ACCELERATE YOUR LENDING

How to respond to the increase in auto sales

Consumer lending trends are starting to increase as credit standards ease and lenders deploy their liquidity to increase earnings. Auto sales are up as the economy improves, creating an increase in direct and indirect lending.

your
CONSUMER SPECIALIST

ANN MEIER
785.438.6143
ann.meier@fhlbtopeka.com

Ann has been in banking for 13 years, all 13 at FHLBank. She is a graduate of Washburn University and the Colorado Graduate School of Banking. Contact her today.

Find out more about Ann and our funding specialists at **FHLBTOPEKA.COM/ INTELLIGENCE.**

According to the Federal Reserve Bank of New York, lenders originated $119 billion in U.S. auto loans in the second quarter of 2015. In an article published in Worchester Business Journal, credit unions funded almost 17% of auto loans in the U.S., an increase of 7.6% year over year. Banks, mainly large national brands, funded 34% of car loans, followed by "captive" finance with 28%. "Captive" finance is defined as financial subsidiaries of car companies, such as Ford Motor Credit. The pie charts below show the breakdown of new and used car loan financing.

A potential cause of the increase in direct and indirect auto loan business may be the relative decline in home prices since the start of the recession, making home equity loans difficult to obtain. This has forced potential buyers back to more traditional auto loans. Some analysts feel this will continue to drive significant growth in this type of lending for credit unions and banks.

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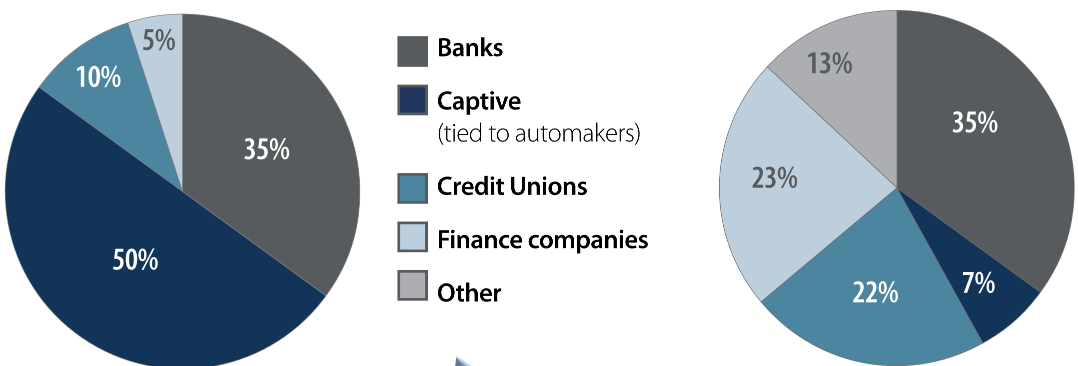
New car loans
(market share as of Q2 2015)

Used car loans
(market share as of Q2 2015)



Source: Experian

continued from page 1

Situation

Consumer lending trends (annualized for 2015 based upon second quarter production) for FHLBank Topeka members show that credit unions are projected to increase new car loans by 12.91% ($546 million) and used car loans by 14.75% ($937 million), while banks in the district are projected to increase auto loans by 6.79% ($196 million).

On the other side of the equation is deposit growth. Loan growth in member credit unions outpaces deposit growth 13.71% to 1.56%, based upon the average growth rates, while bank members see a year-to-date deposit decline of 1.86%. These trends push the average loan-to-shares ratio to 76.16% and the average loan-to-deposit ratio to 73.26%, up 6% and 3%, respectively, over the previous year-over-year numbers according to SNL.

While this is great news for institutions flush with liquidity, this may create funding issues for institutions that are more loaned up. The previous rising rate environment (2004-2006) shows that loan growth, on average, outpaced deposit/share growth.

If history repeats itself, institutions will likely look for alternative funding sources such as FHLBank advances to supplement deposits. During the same time frame mentioned above, FHLBank Topeka's advance balances reached all-time highs as members used wholesale funding to support loan growth.

The current rate environment creates a very attractive buying condition for consumers. Auto loan rates averaged from 2.99-4.74% over the summer, which shows consumer buying power is as high as it has ever been. Data from the past year indicates cost of funds and auto loan rates have remained steady; however, financial institutions should be aware that cost of funds will increase at some point and possibly put margins in jeopardy.

Unfortunately, in a rising rate environment, deposits/shares will reprice quicker than the auto loans, which are booked at terms well above previous norms. According to an article published on cnbc.com, the average age of vehicles on the road is 11.5 years. Prices on new cars and trucks have steadily increased over the past decade, which forces buyers to take out longer loans in an effort to keep payments within their budgets. In a report by IHS Automotive, on average, buyers hold onto their new vehicle for 6.5 years, compared to 4.3 years in 2006. This correlates with the average new car loan of 67 months. Experian reported an increased percentage of loans ranging from 73 to 84 months. While most lenders do not offer exceedingly long auto loan terms, these trends may force their hand, which will lead to unprecedented interest rate risk for this category of loans.

Solution

Hedging auto loans at extremely low loan rates will be a challenge for member institutions. For the most part, auto loans are typically supported by deposits/shares, allowing institutions to use their lowest cost of funding. As liquidity dries up or depositors move

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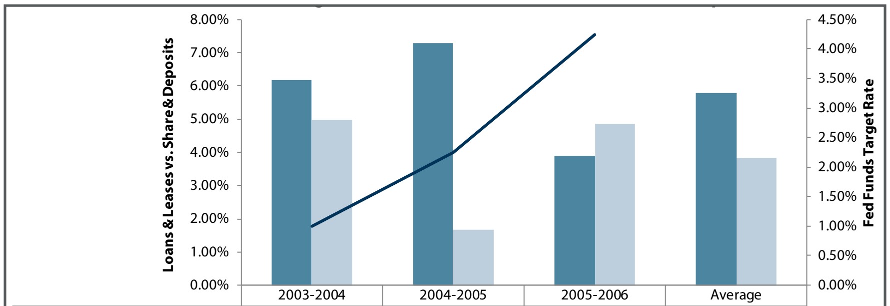
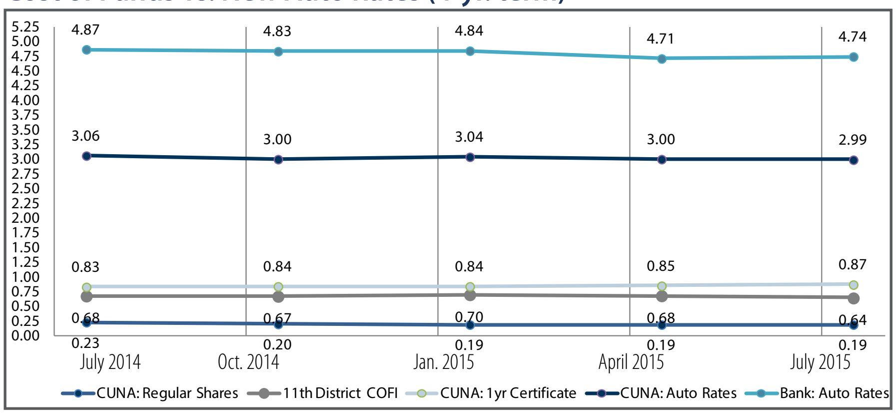
Rising Rate Environment: Loan & Leases vs. Shares/Deposits



	2003-2004	2004-2005	2005-2006	Average
Total Loan & Leases (% Chg)	6.18%	7.29%	3.89%	5.79%
Total Shares & Deposits (% Chg)	4.97%	1.66%	4.85%	3.83%
Fed Funds Target Rate (YE)	1.00%	2.25%	4.25%	

Cost of Funds vs. New Auto Rates (4-yr. term)



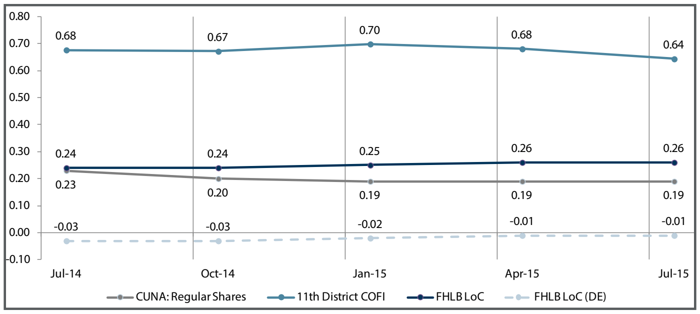
Sources: CUNA Monthly Credit Union Estimates July 2015 and SNL

continued from page 2

to higher yielding assets, members may be forced to look at sources that aren't typically used to fund auto loans. One option in the current rate environment is the line of credit at FHLBank Topeka. Current advance rates coupled with a 6% dividend on activity-based stock could push your cost to borrow funds near or below 0%, actually increasing your margins.

As depicted in the graph at right, the current 6% dividend lowers your effective advance rate to -0.01 basis points if you are utilizing Class B activity stock to support your borrowings.

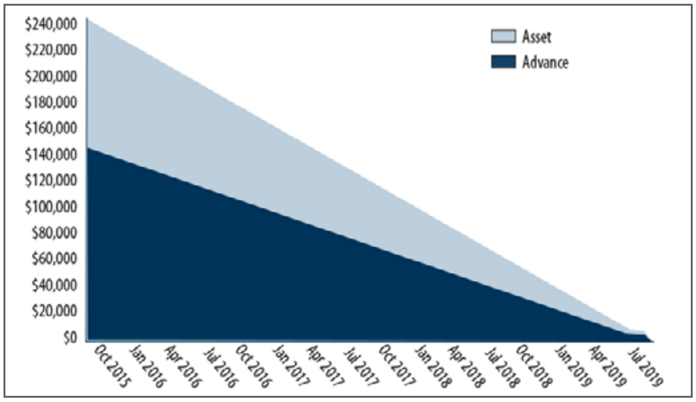
Cost of Funds vs. FHLBank Line of Credit (LoC)



Amortizing Funding Strategy

A more aggressive hedge is to fund with a pool of auto loans with an amortizing advance or a ladder of bullets. Amortizing or bullet advances allow you to lock in a spread while matching cash flows of the hedged loans.

In the scenarios shown, we use a 60/40 split of advances to deposits/shares. Our example is a $250,000 pool of 4-year auto loans at 2.90%. Because of their typical lower cost of funds, using deposits for a portion of the funding increases your spread. Additionally, deposits allow for the absorption of additional principal payments or early payoffs. Keep in mind that this funding approach reduces the spread obtained in comparison to using deposits/shares or the line of credit. It also protects your margins and at the same time gives you 193 basis points in spread over the life of the asset.



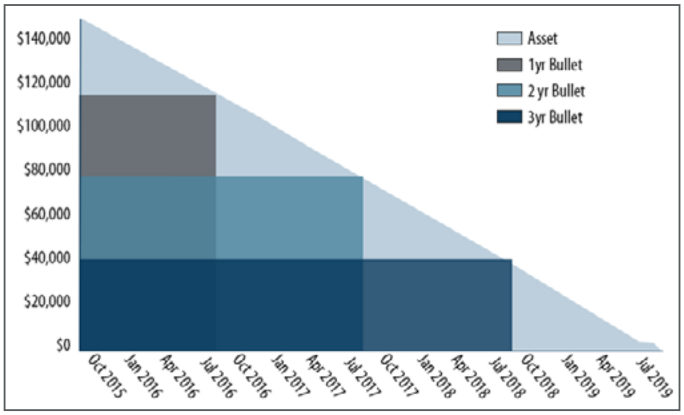
Asset	Advance	Deposit COF	Spread in bps
$250,000 Amort: 48 mo. CPR: 0% Maturity: 48 mo. Principal: Monthly	$150,000 Amort: 48 mo. CPR: 0% Maturity: 48 mo. Principal: Monthly	0.2%	193 initial 193 adv life 193 asset life

Bullet Funding Strategy

The bullet structure generates a higher spread initially that reduces slightly as the lower costing advances roll off. This strategy produces an initial spread of 203 basis points and drops to 194 basis points as the shorter-term bullets mature. Note that funding with bullets creates a little more tail risk compared to the amortized advance structure.

Consumer demand for low fixed rates and longer maturities on auto loans will put your asset liability management to the test. Increasing demand in the consumer lending areas is a positive for our members but with the threat of increasing rates on the horizon, have a plan to protect your margins. Knowing your risk appetite and profitability thresholds will help determine which funding solutions best fit your needs.

Please contact me to discuss different solutions for funding your auto loan portfolio.



Advance Results	Bullet Rate and Spread	Asset Results
Avg. Adv. Rate: 1.08% Deposit COF: 0.2% Initial Spread: 203 Asset Life Spread: 194	3 yr: 1.4%, 190 adv. life 2 yr: 1.1%, 190 adv life 1 yr: 0.72%, 194 adv life	Yield: 2.9% Par: $150,000 Start: Sept. 2015 Maturity: Sept. 2019 Amort: 48 mo. Maturity: 48 mo. Am: Monthly Type: Mortgage CPR: 0%

Contact Ann today for solutions that work for you.

☎ 785.438.6143 ✉ ann.meier@fhlbtopeka.com fhlbtopeka.com/intelligence

FHLBank Topeka