



Managing Regulatory Risk: Perspectives on the Increasing Role of Wholesale Funding

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This change in attitude by the regulatory community is important since most banks continue to be confronted with a very real funding dilemma: assets keep growing at a rate significantly faster than local market deposits. Accordingly, a bank's perspective on and comfort with wholesale funding sources (e.g. borrowings) will drive its liquidity/funds management practices. This will in turn impact strategies for investment portfolio activities, deposit pricing, portfolio lending, and overall balance sheet growth. And the choices made regarding each of these will certainly have a meaningful impact on a bank's earnings.

Important Funding Trends & Statistics

The most important reality associated with the following funding trends is that bank regulators are fully aware of them and their implications for the banking industry.

FDIC (Federal Deposit Insurance Corporation) statistics for all insured banks show that since 1993 assets have grown 6.8% annually while deposits have increased only approximately 4.0%. And embedded in this deposit growth is the accelerating use of brokered deposits. Furthermore, in 1991 deposits represented 79% of bank funding while in 1998 they amounted to only 67%. And while borrowings funded 11% of bank assets in 1991, their role increased to approximately 18% during 1998.

Clearly, the banking industry has been in the midst of a long-term trend of funding asset growth through the increased use of non-deposit funding alternatives. Increased competition from non-banks, mutual funds and credit unions have made it virtually impracticable to raise enough new local deposits to meet balance sheet growth goals without "paying up" considerably and/or risking deposit base cannibalization.

The Infamous CD Special

The above statistics do not imply apathy amongst bankers with regards to this funding plight since most banks have been active in their attempts to attract new

deposit dollars. The most typical strategies have been high yield money market accounts and aggressively priced CD “specials”.

Although these promotions have been successful in producing deposit growth, the effective cost of the new money raised has generally been well above wholesale funding alternatives such as FHLB (Federal Home Loan Bank) Advances and brokered CD’s. When the costs of promotion and of converting existing deposits are included, the true cost of the incremental funds can be significantly greater than what the offered CD rate might otherwise imply. Unfortunately, the cost of cannibalization is often overlooked or not quantified when introducing a new deposit product.

The following chart is an illustration of the Marginal Cost of Funds (MCOF) for new money raised in a 6.00% nine month CD promotion at different levels of conversion from existing accounts that are currently assumed to be costing 4.50% on average.

MARGINAL COST OF FUNDS ANALYSIS

Rate to be Paid on New CD’s:	6.00%
Deposit Rate Paid on Funds Converted:	4.50%

Conversion %*	Cost of New Money
0.00%	6.00%
10.00%	6.17%
20.00%	6.38%
30.00%	6.64%
40.00%	7.00%
50.00%	7.50%
60.00%	8.25%
70.00%	9.50%
80.00%	12.00%

**% of “New CD Product” converted from existing deposit base*

As an illustration of the MCOF, consider a common scenario whereby only half of the funds raised through the promotion are new deposits to the bank. This means that the other 50% were converted from existing accounts. The 1.50% premium paid to the existing depositors (6.00% vs. 4.50%) raises the effective cost of the new money to 7.50%. Are there alternative funding sources readily available to the bank at a materially lower rate? Definitely. Even if it is argued that half of the converted balances would have left the bank if not for the special, the effective cost is approximately 6.50% (by interpolation at a 25% conversion).

The reality is that these new deposits also often prove not only to be more expensive than the available alternatives but also unreliable unless above market rates continue to be offered as CD's mature. The key is to successfully cross-sell new accounts into other products and services since this is the only way to be compensated for the steep initial investment.

Alternative Strategies

So what is the answer? Banks need to have alternative funding sources available when the need for cash arises. These alternatives may include: FHLB Advances, brokered CD's, retail and wholesale repurchase agreements, National Deposit Listing Services and municipal deposits.

Large banks have relied on these funding sources for years while smaller community banks have only recently availed themselves of these alternatives. According to FDIC statistics, large banks (greater than \$1 billion in assets) funded only 43% of their assets with traditional core deposits in 1998 while community banks funded 72%. But this trend has been changing over the past few years as banks of all sizes have accepted the use of these alternatives to fund their growth.

Formalize A Game Plan

In the past, most community bankers and regulators looked at these alternative sources of funds as a sign of weakness. On the contrary, they can provide a bank with greater funding flexibility than local deposits and in many cases should be considered more stable and reliable (e.g. vs. CD specials). The key to utilizing these alternatives is integrating them into a well-defined funding game plan that reflects the liquidity, interest rate risk, and capital profile of the bank.

Also, it is imperative that the bank's asset/liability and funds management policies support this game plan. In fact, policies should include limits on the use of alternative funding sources. Also, the role and use of alternative funding sources needs to be clearly understood by the bank's Board.

In summary, banking industry regulators no longer frown upon the use of wholesale funding as long as it is part of a well-defined balance sheet management game plan.

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