

“Mirror, Mirror, on the Wall, Is My Funding Strategy

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Continued stagnant deposit growth throughout the banking industry mandates that boards of directors and trustees develop a meaningful and cost-effective funding game plan to support the growth requirement of their banks. Successful community banks will be those that formally develop a wholesale funding strategy to complement their retail/commercial deposit generating activities. Far too many banks and their boards remain reluctant to directly address this important issue but for all the wrong reasons. It is my hope that this article will serve as a catalyst for senior bank managements and boards of directors to take a look in the mirror and challenge themselves as to the appropriateness of their funding strategy(ies). In doing so, they will have nothing to lose and the potential for so much to gain.

Historically, the growth rates of local economies provided adequate funding requirements for portfolio lending activities since banks were the repository of choice for household liquidity and savings. As a result, community bank growth strategies tended to be deposit-oriented in nature with the resulting growth generating adequate profitability for meeting required ongoing investment in resources and, for stock banks, providing an acceptable return for shareholders.

Things have changed. Many local economies provide limited growth opportunities with less and less of that growth being captured by community banks, especially as it relates to household liquidity and savings. In the early 1980s, the banking industry held approximately 90 percent of liquid household financial assets whereas today it holds less than 40 percent, and the numbers are shrinking. The growth rate for deposits at FDIC-insured banks was 2.2 percent from 1992 to 1995, with the 1996 growth being around 4 percent, including brokered deposits. The reality is that we as an industry are not even retaining the interest that we pay depositors each year for the use of their money.

At the same time, bank assets have been growing closer to 6 percent, clearly signaling that banks as a whole are no longer capable of meeting credit needs entirely from local market

funding. And with bank capital levels increasing nearly 9 percent compounded annually, there is another stark reality: banks' capacity for growth is outstripping the ability of most local marketers to facilitate their requisite growth. The logical extension of these facts is that relative returns on banking industry capital (return on equity) will continue to come under pressure at a time when shareholder expectations are increasing.

With broader-based competition, the heightened need for improvements in technology and personnel skill sets and continual pressure on margins, it will become increasingly difficult for banks (mutual and stock) to maintain profitability targets. Accordingly, the truly successful community banks of tomorrow will have well-developed growth plans that are more keenly focused on asset growth and that incorporate a meaningful role for wholesale funding to augment deposit-generating activities. The term wholesale funding includes sources such as Federal Home Loan Bank (FHLB) advances, repurchase agreements (borrowings using securities as collateral) and brokered and national certificates of deposit.

Why Are Banks Reluctant To Use Wholesale Funding?

Common themes resonate throughout community banks with a sustained reluctance to use wholesale funding sources for anything other than temporary financing. Reasons for not using wholesale funding usually include one or more of the following:

- Community bankers perceive wholesale funding to be costly. They would rather increase deposit rates than pay a higher rate for wholesale money.
- Community banks have adopted the philosophy that deposits reflect customer relationships while borrowings do not, thus wholesale funding does little to increase the value of a franchise or attain the mission of a community bank.
- There is a perceived lack of spread, especially when financing securities with borrowings, thereby resulting in a lower return on assets.
- There is a perceived negative regulatory attitude, which perpetuates board/management negativity.

Fairest of All?" A Closer Look May Be Necessary

Wholesale Funding Is Not Costly

In lieu of borrowing money, many banks have offered premium CD specials in their local markets at rates equal to or slightly below those for commensurate term wholesale sources. With rare exceptions, the true effective cost of the new money raised was well above the offered rate and the cost of the alternative wholesale funding.

A typical example involves a bank that offered a two-year special at 6.25 percent, which was 5 basis points below the two-year funding cost at its FHLB. The promotion was deemed successful since a significant amount of money was attracted to the product at a lower rate than available in the wholesale markets. In actuality, 50 percent of the dollars attracted was new money at the 6.25 percent rate, while the other 50 percent represented conversions of deposits, which were previously costing the bank significantly less. The net effect was that the actual cost of the new money raised was 7.75 percent, a significant premium even if you assume that some of the existing deposits would have left the bank if not for the special. The reality is that the cheapest form of marginal funds is typically in the wholesale markets. This is not to suggest that banks should abandon local market deposit generation, but rather that they develop a more complete understanding of the true cost of raising incremental funds in alternative markets.

Deposits Equal Customers?

It is true that deposits provide an opportunity to cross-sell other bank products and services to the underlying customer/household and, everything else being equal, should be worthy of a premium. In the CD special example above, it is also true that the new money attracted is more reflective of a temporary acquaintance than it is of a customer. Little is typically done by banks to test the cross-selling capacity of these new "customers" (or the bank's ability to sell).

As a result, time quickly passes with the new deposits merely representing nothing more than borrowings at an above-market cost with less reliability for renewal than, for example, an FHLB advance. It is difficult to argue that high-cost, deposit-generating activities (i.e., an investment), without action plans

to cross-sell (i.e., return on investment), will enhance franchise value. At the very least, senior management and boards of directors may want to consider using wholesale sources to meet incremental funding needs until more value-added, deposit-generating programs can be developed and implemented to attract and retain new deposits. How do the additional earnings associated with cost-effective wholesale activities do anything but better enable the bank to attain its mission as a community bank?

Lack of Spread

Facing limited local market growth opportunities, many banks have considered using borrowings such as FHLB advances to fund the purchase of investment securities only to conclude that the available spreads are insufficient. Senior managers usually determine that the resulting after-tax spreads were below their banks' return on assets (ROA) and, therefore, quickly lose their interest (often because incentive compensation is based on ROA targets). While it is beyond the scope of this article to discuss why ROA is the inappropriate focus for a bank's decision making, a few points are important to mention.

While banks are scrambling to generate sufficient growth, it is not uncommon for their profitability benchmark (i.e., ROA) to be counterproductive in this regard. As a result, in the name of preserving balance sheet margins, banks forego growth, increase capital ratios (i.e., in manufacturing terms they build more excess plant capacity which represents increasingly greater levels of opportunity cost) and leave more and more money on the table. This is akin to a plant manager of a furniture manufacturer operating at 75 percent of plant capacity turning down an opportunity to produce additional products (only using 5 percent of capacity) because the resulting return on sales of say 20 percent (which would not disrupt future pricing) was less than the targeted 35 percent.

As an owner of that company, you would not be very pleased with the decision of your plant manager: 20 percent on additional production is better than 35 percent of zero new
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production. Why then are we comfortable with ROA-based decisions at our banks which are essentially the same as those made by the plant manager in this example? This is why all banks need to examine return on equity (ROE) as being the appropriate focus.

Another issue frequently arises when banks mention spread as being insufficient to justify loan (typically residential) or security transactions funded with wholesale sources. Implied is the assumption that all transactions must be funded on a matched basis to avoid taking interest rate risk. This perspective assumes that the bank is presently operating without any interest rate risk, thereby requiring that incremental transactions be matched to preserve that profile. In reality, most banks are positioned to benefit from either rising rates (asset sensitive) or falling rates (liability sensitive). Matched transactions will not reduce the existing risk. In fact, reducing interest rate risk can be accomplished with a mismatched transaction. For example, an asset-sensitive bank (hurt if rates fall) desiring to simultaneously increase earnings and reduce interest rate risk could originate/purchase a fixed rate asset and fund it with a shorter term borrowing (transaction benefits if rates fall). Doing so would prudently provide a greater spread than the matched transaction and result in a higher level of more sustainable earnings for the bank.

Regulatory Concerns and Fears

Regardless of past experiences or grapevine "war stories," the regulatory position is clearly stated: Borrowings and brokered CDs are acceptable funding sources to the extent that they are part of an overall funding plan of the bank.

This position continues to be reconfirmed regularly in the field, especially by national regulatory agencies (OCC, FDIC, OTS and the Fed). Banks that are confident in their use of wholesale funding and can clearly document how these funding sources result in improved earnings, liquidity management and interest rate risk management should not have concerns regarding regulatory perspectives. This important point was openly confirmed by bank regulators attending recent FHLB educa-

tional programs in various parts of the country (including Topeka's *Keeping the Wolves at Bay* workshop series). With increasing frequency, bankers and their regulators are acknowledging that borrowings cannot be bad, by definition, especially considering that deposits are borrowings which are, in effect, secured by a bank's asset base via FDIC insurance.

Importance of Policy Statements

It is important that appropriate liquidity/funds management policies be developed that incorporate the role of various wholesale funding alternatives. The policies should incorporate a general discussion of the circumstances for which wholesale funding will be used. Policies should also reflect the use of a liquidity measurement that monitors remaining access to such sources for both operating and contingency purposes. Limits then need to be established for minimum levels of remaining access to liquidity sources. These measurements must become a staple of the asset/liability management committee and be monitored by the board of directors at least quarterly. They become an invaluable input for setting deposit rates and developing ongoing investment strategy.

If funds management policies are to be meaningful, they must reflect the realities of the environment in which banks operate. And since the current environment continues to rapidly evolve, appropriate education at both the management and board levels must be considered a critical component of policy development.

While raising deposits will always be preferred to borrowing money in the wholesale markets, it is imperative that community banks come to grips with the reality that traditional local market funding growth will continue to be insufficient to meet the funding requirements of the banking industry. Banks whose management and boards of directors reflect this in the ongoing management of their banks will definitively experience higher earnings levels. Increased earnings (and improved ROE) can only lead to community banks being better positioned to compete for the financial services of the households and businesses in their local markets as well as to maintain their independence.