Funding Strategies

When Traditional deposits fall short, it's time to look at wholesale funding strategies.

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One of the most pressing issues for banks today is the ability to fund the balance sheet at a cost effective level. Over the past two years of Federal Reserve tightening, overall cost of funds throughout the industry has escalated significantly while asset yields have increased at a more sluggish pace. The most recent data (source: FDIC SDI) indicates a 118% increase in cost of funds (all FDIC insured institutions) since June 2004, with only a 23% increase in earning asset yields over the same timeframe. The reason: while funding costs tend to reflect the short end of the yield curve, the majority of bank assets are more tied to the term structure of rates (3, 5, 7 and 10 years). As a result, net interest margins have narrowed significantly.

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In the current environment, many banks have come to the realization that they have little control over the yields on their assets as they are very much a function of the competing market place (i.e. commodity like). In addition, they are better understanding that the most expensive funding source can often be local, rate sensitive, depositors who want the best rates but, at the same time, want to keep their funding flexible and in short term investments. Is this type of customer a profitable relationship for the bank, or would the bank be better served to selectively reduce rates and allow rate shoppers to shop somewhere else?

This raises the question as to what the right mix of funding should be for any particular bank. What should the mix be between retail deposits and wholesale funding that provides the overall lowest cost of total funds; but provides the flexibility to manage the liquidity and interest rate position of the balance sheet?

Most banks that have traditionally relied on customer-only deposits to fund their balance sheets are at a tactical disadvantage. With the preponderance of new loan assets being fixed rate for at least three to five years and depositors wanting to keep maturities short, there is little ability for a bank to effectively manage their interest rate risk position and net interest margins.

What most banks need is the ability to acquire funding that is not only cost effective at the margin, but, also has the maturity characteristics that best meet the interest rate characteristics of the balance sheet. Wholesale funding in the current flat/inverted yield curve environment can meet these requirements.

Whereas, banks having difficulty attracting local deposits with maturities of twelve months or more (at a price they are willing to pay), there are many attractive longer term funding alternatives in the wholesale markets. These include:

- Federal Home Loan Bank Advances: Available in both bullet, putable (the FHLB has the option) and capped structures, these alternatives often provide rate protection at rates below what are required to raise money from local depositors (Note: The cost of raising local deposits is *not* just the rate on a given product, it is the rate plus the cost of conversion (marginal cost of funds) of existing customers to that "premium" account).

- Wholesale Repurchase Agreements: Also available in the bullet, putable and with embedded caps and/or floors (which also allow for up to a 2x leverage factor of the embedded option, should your interest rate risk position call for the additional protection). These alternatives may be less expensive than either local deposits or FHLB advances.

- Brokered CD's: Available in either bullet or callable structures (the bank has the call), these CD's do not require collateral, are usually less expensive than raising new local deposits at the margin, may be less expensive than FHLB advances (when day count and frequency of compounding is considered) and also may provide more structural flexibility than other wholesale alternatives.

Conclusion:

While a bank's core customer base continues to be the "franchise," wholesale funding strategies, when combined with selectively reducing rates on higher cost local deposits, could very well result in lower overall funding costs and reduced balance sheet risk.

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As a Managing Director of Darling Consulting Group (DCG), Keith has over 10 years of experience working directly with community banks to help them improve overall performance through proactive management of liquidity, interest rate risk and capital, and by developing strategies that best fit the risk/return dynamic of their balance sheets. Keith recently served on the faculty of the ABA's *Stonier School of Banking*, and has written articles for a variety of professional publications. He received a B.S. in Business Administration/Finance from the University of New Hampshire. Keith lives in southern New Hampshire with his wife and two children.

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