Wholesale Funding – A Required Management Tool

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The Issues

Over the past 18 months, many financial institutions have been subject to criticism with respect to using wholesale funding to support their balance sheets. In fact, many have been directed to reduce their levels of wholesale funding and to increase their levels of retail deposits–regardless of the costs or the fact that these funding sources pose little or no threat to the viability of the financial institution. Indeed, financial institutions that follow these directives to the letter could well be creating significant future risks to their balance sheets and impairing current profitability needed to regenerate capital levels or cover increased levels of operating expense.

These concerns may be misplaced, as they are based on the questionable assumption that financial institution failures, during this or prior economic downturns, have been due to rapid asset growth supported by wholesale funding sources such as brokered CDs and Federal Home Loan Bank (FHLBank) borrowings. The argument goes something like this: Had these sources not been available, these institutions could not have funded the toxic assets (either loans or investments) that led to their downfalls. This is similar to doctors treating symptoms and not the disease.

Financial institutions fail because of poor asset quality and underwriting, not the funding sources they utilize. Yes, a liquidity crisis can be the final blow to a financial institution, but the liquidity crisis is almost always the result of asset write-downs and/or loan charge-offs. The current phobia regarding the use of wholesale funding will probably result in more institutions failing than necessary, if they have no choice but to contract their balance sheets or pay up for retail deposits in order to reduce their dependency on wholesale funding.

The Need for Wholesale Funding Sources

For the last 30 years, I have urged institutions of all sizes to diversify their sources of funding. Funding from a single source (i.e., local retail deposits) is akin to a manufacturer having only one source of raw materials. At any time, that one supplier may demand a higher price for their funds, decide to invest in other investments (i.e., stocks, bonds, mutual funds), or to simply spend their money, leaving the institution vulnerable to a liquidity

shortage. Every financial institution needs a variety of funding sources to ensure funds availability at reasonable costs and the right structures to meet balance sheet needs. The wholesale sources available to community institutions are primarily limited to the FHLBanks, brokered CDs, national market CDs, and the Federal Reserve Bank. Each of these sources has different characteristics and risk/return trade-offs.

As much as diversification, financial institutions also need wholesale funding sources for managing funding expense, interest rate risk, and liquidity risk.

From a cost perspective, a financial institution is always confronted with the need to understand its marginal cost of funds. In most situations, especially for institutions with large local market share, raising new funds through deposit specials can result in a high marginal cost of funds because, for every new deposit raised, there is additional cost for each existing deposit that "converts" or "migrates" to the new special. For example, if a financial institution offers a new deposit account at 1.50% to raise new deposits and 50% of the balances come from existing accounts costing .50% (50 basis points), the cost of the new money "at the margin" is 2.50% (1.50% + 1.00% paid up on existing deposits).

Another issue created by total reliance on local deposits is how to manage exposure to interest rate risk. In today's environment, most borrowers want long-term fixed-rate loans (5-30 years). At the same time, depositors today are "parking" deposits short term. As each day goes by in this low-rate

environment, the interest rate risk to financial institutions originating loans and accepting deposits increases. The use of wholesale funding to extend maturities at a reasonable cost is essential to the management of the interest rate risk that is an integral part of the financial intermediation process.

Finally, the current build-up of local deposits in financial institutions is similar to that of the previous economic downturns the U.S. has experienced. Consumers constrain spending and save more. Investors "park" money in a safe place where the yields, although low, are still better than many other alternatives. And businesses contract spending and build liquidity putting off capital expenditures and hiring until they can see clear signs of a recovery. Once the recovery begins, deposit balances in financial institutions will decline at the same time that loan demand is increasing. Consumers will spend and borrow more, investors will invest, and businesses will spend and borrow to expand. The result for those financial institutions that do not have adequate wholesale funding sources available will be significant increases in funding costs (higher marginal cost of funds), and potential constraints on lending so they can maintain adequate levels of liquidity.

Conclusion

Current negative attitudes towards wholesale funding are misguided and misplaced. Wholesale funding alternatives must be a part of every financial institution's liquidity and funding plan to ensure a safe and sound operation of the intermediary function. Cutting off or severely restricting access to wholesale funding will diminish profitability, constrain lending and

hurt the economy, and expose a financial institution to increased interest rate and liquidity risk.

Financial institutions must have wholesale funding sources available and be willing to use them if they believe it is the right business decision.

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Mr. Darling's professional experience includes: thirty years with his own company, two years as a senior executive with a $2 billion financial institution; two years with a Big Five Accounting firm and ten years with IBM. He is a nationally recognized resource for assisting financial institutions in the areas of interest rate risk management, liquidity management and capital planning.

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