

ALCO BEAT: Don't trash a trusty hammer! (February 26, 2010)

Wholesale funding remains a critical tool regulators shouldn't remove

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By George Darling, CEO, Darling Consulting Group, Newburyport, Mass., gdarling@darlingconsulting.com, www.darlingconsulting.com

The joint agency "Advisory on Interest Rate Risk Management" released on Jan. 6, 2010, was both timely and appropriate—but I say that with a "but." With this advisory the regulators have put the banking community on clear notice that they will be elevating their focus on the appropriateness of their interest-rate-risk management process and related risk-measurement activities. There is no question that the longer this historically low-rate environment continues, the greater the banking industry's potential exposure will be to rising rates as borrowers opt for longer-term, fixed-rate loans while depositors park money in shorter-term certificates of deposit and non-maturity accounts. (Editor's note: On Feb. 24, Federal Reserve Board Chairman Ben Bernanke told Congress that the exceptionally low-rate environment would continue for an extended period. Read more.)

However, while challenging the banking industry to improve interest-rate management processes, the regulatory agencies have also re-established and re-emphasized their old aversion and distaste for wholesale funding sources, specifically brokered certificates of deposits (CDs) and advances from the Federal Home Loan Bank System (FHLBS). The pressure in this area is often applied by lowering liquidity grades on regulatory exams for those banks that make use of what examiners deem "excessive" borrowings. This message has caused some banks to curtail lending and growth, in order to reduce borrowing levels to appease the regulators. This creates a "no win" situation for most community and regional banks.

This paper, an expansion with fresh data and research on an earlier column for ABABJ.com, attempts to identify the issues and explains why wholesale funding must be a necessary part of any bank's interest rate risk management strategy.

The issues

In today's historically low-rate environment, most bank borrowers desire to lock in rates on loans for an extended period of time (five years to ten years or longer). At the same time, depositors are choosing to "park" monies in short-term CDs and/or non-maturity money market or savings accounts. As a result, the exposure of the banking industry's net interest income to a rising interest rate environment increases with each passing day.

My firm, the Darling Consulting Group, recently reviewed the impact of rising rates on the net interest income of the 297 client banks in our proprietary database, which contains both current and historical balance sheet risk profiles. These clients are located in 46 states and represent combined assets of \$260 billion. Currently, the combined annual net interest income of these banks is over \$8.5 billion. Table I, below, shows the expected impact on net interest income of rates increasing over the next two years to the level of rates in the U.S. as of August 2007. At that time the yield curve was flat, with the federal funds target rate at 5.25% and the 2, 5, and 10 year U.S. Treasury rates at 4.15%, 4.25%, and 4.54%, respectively.

TABLE I

Projected NII (000's)

AUGUST 2007 ENVIRONMENT

Years
 Base (No Rate Changes)
 NII (000's)

Diff (000's)

%Change

1
 \$ 8,572,483
 \$ 8,345,151

(227,333)

- 2.65%

2
 8,953,561
 8,222,058
 (731,503)
 - 8.17%

3
 9,043,511

7,956,477

(1,087,034)
-12.02%4
9,115,563
8,210,921
(904,642)
- 9.92%5
9,141,182
8,596,157
(545,025)
- 5.96%\$44,826,301
\$41,330,764

\$(3,495,537)

- 7.80%

Table I shows that, over the five year horizon, it is only in the fifth year that NII recovers to current levels.

Déjà vu all over again?

If we roll the clock forward and return to a similar flattening yield curve environment that we witnessed in August 2007, our analysis shows that most banks will likely experience some significant exposure to NII.

Table II below shows the number and percentage of the 297-bank sample that have varying levels of cumulative NII exposure over the first three years of the rising-rate, flattening-yield-curve environment. Banks with over 5% cumulative NII at risk represent just over 54% of the sample.

TABLE II

Cumulative %

NII Exposure

Number of

Banks
% Banks

- 2%
200

67.34%

- 3%
186
62.63%

- 4%
174
58.59%

- 5%
161
54.21%

Based on the level of interest-rate-risk exposure outlined above, many of the banks in this group should be developing plans and strategies to reduce some of their exposure to rising rates. Unfortunately, the more efficient and effective options available to reduce the interest rate risk embedded in these banks' balance sheets are becoming increasingly limited. As a result of the recent credit meltdown, the onerous accounting constraints imposed by FASB 133, and both regulatory and legislative scrutiny, the use of interest-rate derivatives such as interest-rate caps, floors, and swaps have become either too risky or cumbersome for most banks to use to reduce interest rate risk.

Historically, the second, more likely option that bankers might consider to reduce exposure to rising rates would be the extension of wholesale funding, either with brokered CD's or with FHLB advances. This funding has traditionally been available in low-rate cycles in meaningful volumes and at costs significantly below term funding in local markets. Unfortunately, the current negative regulatory perspective of these funding alternatives has caused many bankers to shy away from these sources for fear of criticism and potential downgrades to their CAMELS rating.

This leaves bankers with only two options in their local markets:

- Write all loans on a floating-rate basis, to shorten asset repricings; or,
- Extend CD maturities to better match the terms of loans being originated.

The first option of only offering variable-rate loans is unrealistic if borrowers insist on longer-term structures that are available from competitors. The second option of extending deposit maturities is equally as difficult to accomplish. Most local depositors are unwilling to sell the bank money in the form of longer-term CDs.

What's wrong with wholesale funding?

Based upon what I've heard from bankers throughout the country, bank regulators are strongly discouraging the use of wholesale funding on bank balance sheets. The regulatory rationale for this position is that wholesale funding is more expensive, more interest-rate sensitive, and less reliable from a liquidity perspective than local market deposits. Additionally, regulators often blame wholesale funding sources for allowing banks to grow rapidly by originating high-risk loans (i.e. the use of wholesale funding, especially brokered CDs, is a major contributor to bank failures).

Since this negative attitude toward wholesale funding is widespread in the U.S., banks throughout the country are "paying up" in an attempt to attract more "core deposit" customers. This has led to rate wars and declining profitability in many geographic areas.

The question arises, "Are these funds really core deposits or are they rate-sensitive monies that will leave the bank when there are more attractive alternatives available elsewhere?"

Either way, the end result is a higher cost of funds for all banks both today and in the future. As a result, it is probable that banks will: need to charge more for loans; have lower operating income; generate less capital to support future lending; and, have increased levels of liquidity risk and interest rate risk than they would have if they had used FHLB advances and/or brokered CDs.

A better road

The prudent use of wholesale funding alternatives can: reduce interest rate risk; improve earnings; and, increase balance sheet liquidity.

- **Reduced interest-rate risk:** Term funding available from the FHLB or brokered CD market has significantly less optionality than local deposits. In most cases, FHLB term funding cannot be withdrawn from a bank so long as adequate collateral is pledged. In the case of brokered CDs, there is no early withdrawal allowed, except for a "death put" (e.g. the depositor must expire for early redemption). Most local deposits can be withdrawn without penalty or with a three- to six-month early withdrawal penalty.

- **Improved earnings:** Wholesale funding, especially term funding, is usually available in volume and is ordinarily less expensive than raising deposits in the local market. To obtain term funding usually requires high-rate "CD specials";

For example, current FHLB advances for one year are available for 55 basis points, while 13-month CD specials are offered at 2.25%. These specials not only carry a high nominal rate, but also usually result in conversion of monies from other, lower-rate accounts within the bank. This results in a significantly higher marginal cost of funds for the term funding being raised. Wholesale funding is often the most cost effective alternative. This is particularly true today!

- **Increased balance sheet liquidity:** The use of wholesale funding sources often results in improved balance sheet liquidity. For example, if an FHLB advance, using otherwise "illiquid" loans as collateral, is used to purchase an agency security, balance sheet liquidity improves. If a five-year brokered CD is used to replace a short-term municipal deposit collateralized with securities, liquidity is improved by "freeing up" security collateral and extending a deposit to five years where there is no "early withdrawal" option (with the exception of the death put).

Used properly, wholesale funding is a very effective liquidity management tool. There is no definitive evidence that the

use of wholesale funding, specifically brokered CDs, is a culprit in bank failures. The banks that have failed in this economic downturn have failed because of poor asset quality and/or excessive credit-risk concentration. The use of wholesale funding to support this lending was a symptom and not the cause of their demise.

Assessing genuine risks

Without question, there are risks associated with wholesale funding sources. These risks vary depending on the source, but can be categorized as credit-sensitive risk and legislative and regulatory risk.

• Credit-sensitive risk: Funding sources that are collateralized either by securities or loans are at risk because of the underlying collateral that secures this type of funding. If loans become delinquent or default, this collateral must be replaced or the lender has the right to cancel the borrowing and demand immediate repayment. Borrowings secured by investment collateral are subject to margin calls if the value of the securities pledged falls below a stipulated level. If additional collateral is not forthcoming, the lender has the right to cancel the borrowing and liquidate the collateral.

Brokered CDs can also be considered as credit sensitive in that, if a bank fails, any brokered CDs in that bank immediately stop accruing interest. Even though principal and interest are insured up to the date of bank closure, there is often a delay between the date of closure and when the CD customer may receive payment from FDIC. Most brokered CD customers understand this risk and are, therefore, hesitant to renew or place CDs at banks with deteriorating balance sheet positions.

• Legislative and regulatory risk: The focus of most legislative and regulatory risk is primarily directed at brokered CDs. The FDIC Improvement Act of 1991 prohibits banks that are below a "well capitalized" status from issuing or renewing brokered CDs without a written waiver from FDIC. Also, banks under formal regulatory enforcement orders are ordinarily also prohibited from issuing or renewing brokered CDs without a written waiver. Banks that issue brokered CDs should be aware that these waivers are rarely granted.

Every banker that uses wholesale funding needs to be aware of the risks associated with each funding alternative and take these risks into consideration as part of their contingency funding plan.

Bankers face unenviable choice

As a result of regulatory pressures to reduce dependence on wholesale funding in favor of local deposits, an increasing number of bankers are being faced with choosing the lesser of two evils. Would they rather be criticized for their dependence on wholesale funding or for ever-decreasing net income and increasing exposure to liquidity and interest rate risk?

Regulators need to become more realistic about the funding needs of the banking industry. They need to stop vilifying the use of wholesale funding and recognize that they are a necessary part of the funding mix for every bank; either because they are more cost effective or because they play an important role in the management of liquidity and interest rate risk.

By the same token, bankers need to understand the risk/reward of these funding alternatives and be prepared to justify the use of non-local funding sources to regulatory agencies and articulate why they believe they are important balance sheet management tools.

Each bank should have a clear understanding and be able to explain: the business purpose; the reliability and; the cost effectiveness of each funding alternative. They need to demonstrate that, while they want to please regulators, they are not going to jeopardize the viability of their banks by impairing earnings and taking on potentially fatal levels of liquidity and interest rate risk that may result from an unrealistic dependence on local deposit markets.

Other ABABJ.com articles by George Darling

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