

## WHY DO YOU THINK THEY CALL IT 'CORE'?

A lender's-eye look at a basic of bank funding—and its increasing relevance to the future

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There was an article the other day in the national financial press on how FDIC is having difficulty generating interest for some banks destined for closure in the immediate future. This is due to a handful of primary reasons that bear directly on the future of community banking and community banking business models.

First, many of these very sick banks have real estate concentrations in their portfolios. Real estate deals, even at significant discounts, are not as attractive today as they were as recently as two or three years ago. How long this aversion to real estate will last is a major uncertainty in the assessing of community bank lending opportunities in the near to intermediate future.

Second, many banks identified for probable closures are located in parts of the country where loan growth prospects are less than robust. Why should a healthy bank seek to increase its market presence by acquisition in any geographical area that does not offer reasonably good loan growth opportunities?

Perhaps the most important reason of all is the fact that so much of the expansive lending in recent years has been fueled by non-core funding sources.

The supervisory authorities have been quite concerned about, and critical of, banks where funding was overtly dependent on non-core funding. This is so because non-core sources generally command a premium yield, while amounts up to \$250,000 enjoy the FDIC guaranty-in competition with everyone else. Further, closing these banks with depositor payouts puts additional strain on the resources of the Deposit Insurance Fund.

The essential value of core

This concern about non-core funding has been a startling realization for some bankers. Banks without strong core funding sources simply have less value than those institutions that draw deposits from their local communities in significant volumes. Why is this so?

Core depositors are those that have traditionally done business with banks on a face-to-face basis. They bank where they do for service and convenience. And they have ongoing relationships, often multiple ones, with their bankers.

Another way to think of this is "franchise" value. What's the franchise value of a bank in Washington State that generates much of its deposits from individuals and businesses in remote geographies and based on rate, and with no other business relationships with the bank?

The regulators define core deposits specifically and the designation is limited to depositors who have balances of \$100,000 or less. This is the old FDIC limit that was raised to its current limit almost two years ago when the current financial malaise began. Raising the amount of the defined limit of "core" was considered at the time but ultimately left unchanged.

This is not necessarily the whole story of how regulators expect that we should fund our banks. There are face-to-face sources that aren't always in deposit form, such as Fed funds purchased from correspondent banks where established business relationships exist. But the driver of conservative funding is a generous mix of core deposits.

If a bank does not enjoy an abundance of core funding sources and the prospects of loan growth for the intermediate future are anemic, then is it any wonder that the bank is not as valuable a property? Contrast this to other banks differently situated in growing markets and with loyal and deep community funding sources.

#### Core makes cheaper fuel

Many years ago, as a young lender learning my trade at The Bank of New York, the culture valued core deposits. This was to some degree true because banks, even large money-center institutions, had fewer funding alternatives than they enjoy today. This is particularly so of smaller institutions where the gradual increases in FDIC coverage and the relaxation of historical restraints of Regulation Q (limitations on what banks could pay for deposits) have effectively removed geographical and psychological barriers to deposit generation.

While stability of sources is a virtue, there is another important one as well—price. Core deposits are cheaper than non-core deposits.

Some of this is due to the limitations of interest payable on commercial checking deposits of businesses but basically, it comes from the steady and sure balances generated by customers who bank with us for convenience. It's not that these customers are unconcerned about a fraction of a point, but more that it isn't convenient in their day-to-day operations to chase the last basis point in yield or the last dollar of expense.

#### Why core ultimately matters

There is one other very important aspect of funding that I learned at The Bank of New York in the 1960s. It was the strong belief that a principal purpose of lending money is to generate the core sources of funding in the first place.

Banks can always choose to buy securities as an alternative to making loans. The spread on loans over securities favors lending, to be sure, but it's not the only alternative banks had then or enjoy now.

What a novel idea: make loans to generate deposits.

Can the answer to our futures be right under our noses?

If so, it will take a paradigm shift on our parts in the way we approach our customers.

One day, loan demand will recover.

As that process evolves, we need to reorient our approach to our borrowing customers.

This is, after all, the way business used to be done.

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Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

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