Wholesale funding isn't toxic! (July 30, 2009)

Why is this basic of modern banking confined to the doghouse? An ALM veteran makes the case for letting it out

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It has been interesting to observe the regulators and the press in their recent vilification of the banking industry’s use of wholesale funding to fund balance sheet growth … especially the use of brokered certificates of deposit.

It sounds very familiar, and here is why.

It is reminiscent of a study published by the Office of the Comptroller of the Currency (OCC) over 25 years ago. The study made this conclusion: Because all banks that failed had brokered CDs on their balance sheet, therefore brokered CDs must be a major contributor to bank failures.

This is a perfect example of treating symptoms and not the disease.

The use of brokered CDs and wholesale funding is not—and never has been—responsible for bank failures. Banks fail because of bad asset quality!

The use of wholesale funding combined with rapid asset growth should have prompted questions from regulators as to the concentration and types of assets being funded. The funding, in and of itself, has not been the problem.

Why wholesale funding?

Historically, funding for a bank’s balance sheet was obtained from its local community in the form of deposits. This was especially true when deposit rates were regulated and there were few other options for individuals and businesses to invest or safekeep their monies. However, today, consumers and companies have many choices in addition to traditional banking entities: insurance companies, mutual funds, credit unions, finance companies, investment advisors, etc. are all in competition for these funds. The internet has also made these alternative choices just a simple click away.

Any financial institution that depends solely on raising deposits from its local marketplace may find it difficult to manage both its liquidity and interest rate risk in a cost-effective manner. Dependence on this single source of funding would be akin to a manufacturing company relying on a single vendor for all its raw materials.

Wholesale funds come from multiple sources

Wholesale funding can be obtained from a variety of different sources. These sources include collateralized funding from the Federal Home Loan Bank System; wholesale repurchase agreements; or borrowings from the Federal Reserve Bank. Additionally, unsecured funding is available in the form of insured deposits either issued through third parties (e.g. brokers) or placed directly with a financial institution through national listing services.

These wholesale sources offer a number of distinct benefits over raising deposits in a local marketplace.

1. When raising local deposits, a bank is never sure of the rate required to be successful. If the rate offered is too high, then money often flows in at a cost and volume that can be onerous. If the rate is too low, deposits will not flow into the bank.

2. The customer determines the maturity that best suits his/her requirements. For example, if the financial institution needs five-year money and the customer only wants to invest for 12 months, then there is a disconnect between what the bank and customer each want.

3. To raise new funds in a local market, most banks experience a higher cost of new money than comparable funding in the wholesale markets, even without factoring in marketing, sales and administration expenses. The larger a bank’s share of market, the higher the marginal cost of funds is for new money because of the “conversion” of existing funds into the “special” offer.

4. Wholesale funding is more reliable than local deposits. This is because of the underlying contractual nature of wholesale money, (e.g. no early withdrawal allowed for brokered CDs, no call features in most wholesale borrowings, etc.).

And there are these benefits, when broadly comparing raising money in local markets to using wholesale funding, wholesale funding:

• Wholesale is available in bulk (not a lot of small CDs or accounts).

• Wholesale allows the financial institution to choose both structure and maturity.

• Wholesale is available at a known up-front cost.

• Wholesale provides a better tool for managing both liquidity and interest rate risk.

Unintended consequences

Unfortunately, because of the negative attitude of regulators toward brokered CDs and wholesale funding, many bankers are shying away from using them.

What this will mean to the economy over the short term will be reduced available credit and lethargic growth.

Over the longer term, this negativity could result in less income to recapitalize the financial system and, more importantly, more liquidity and interest rate risk when rates begin to rise again in the future and money that is currently “parked” in the banking system flows into other, more attractive alternatives.

It is critical for the future success of the financial system for regulators to stop demonizing the prudent use of wholesale funding. These types of funds are an essential tool for the management of liquidity and interest rate risk. To preclude their usage will result in more bank failures and less available credit to support economic growth. In addition, it will take away one of the most important tools available for managing balance sheet risk.