MARGINAL VS. EFFECTIVE COST OF FUNDS

by Steve Brown

Like the age old debate between ROA vs. ROE, the discussion over whether to use marginal or effective cost of funds when determining loan profitability is equally perplexing. Up until the early 1990's, there was little discussion, as most bankers used effective cost of funds in their calculation. This calculation includes the funding cost for a bank's entire balance sheet, including non-interest bearing deposits. By 1997, bankers caught on to customer profitability and funds transfer pricing with its inherent biased towards using marginal cost of funds when pricing, because that is the decision point of profitability Â– whether to book the next loan. To get a clearer picture of the debate, let's take a $5mm floating rate loan priced at Libor + 120bp. First Sample Bank is growing rapidly and as a result, has utilized many of its local funding sources to the point that it has to borrow additional funds at Libor + 20bp. This marginal cost of funds leaves the bank with a paltry 100bp margin, so the loan is declined. Let's look at it another way. First Sample Bank, however, also enjoys a solid core group of liabilities complete with a healthy dose of non-maturity and non-interest bearing deposits. As a result, the Bank enjoys a current effective cost of funds of 2.40%, or approximately Libor Â– 300bp (even with the addition of $5mm of wholesale funds at a higher rate). When calculated in this manner, margins are 400bp and acceptable to management given the credit risk - the loan is made. We just looked at one scenario with 2 calculation methods each yielding a different outcome. Which way is correct? While it is true that making the loan in question decreases the marginal profitability of the bank, net income is only increased if the loan is made. We agree with this outcome and the foundation of our argument is rooted in the fact that deposits are fungible, both as to time, structure and pricing. A $5mm deposit that came to the bank 3Ys ago is no more or no less attributable to a loan made today. Promoting a concept of match funding is liable to lead to sub-optimal decisions, particularly in periods of high leverage and rising rates. Banks that use the marginal cost of funds in their calculations in environments such as today's, have a tendency to be biased towards originating either higher yielding/lower credit quality transactions or smaller sized transactions. Both of these outcomes often produce below average risk-adjusted returns. Another pillar of our argument lies in the fact that when it comes to bank valuation, effective, not marginal costs are used to value both assets and liabilities. Thus, in terms of risk, managing effective costs is more important. Using a marginal funding calculation does not place value in a bank's ability to grow its core deposit base. To clarify, we whole heartedly support using the marginal cost of funds to attribute profitability, just not when decisioning a loan. The value of lending, in our opinion, is derived from an excess return above the risk and above the cost of capital. The value of deposit gathering on the other hand, lies is aggregating deposits below the market (usually pegged at the wholesale cost of funds level). The attribution of profit within the institution is a different exercise than determining the overall profitability of the next deposit or the next loan. By utilizing a bank's effective costs of funds, better lending decisions can be made.

NEED DEPOSITS?

We have a special situation in connection with our June 9th deposit securitization. We need 19 banks by 5pm ET that are interested in issuing $100k of 1Y CDs at 5.00% (act/act). This is 15bp below Libor. Banks will be taken on a first come basis. For those that are interested, click the link below to electronically register for the deposit. http://www.bancinvestment.com/products/liabilities/portfolio-deposits.html

BANK NEWS

Acquisition

Inland Bancorp Holding ($312mm, IL) will acquire Cambridge Bank ($306mm, IL) for an undisclosed sum.

New President

The Philadelphia Fed named Charles Plossner as the its new president, replacing Anthony Santomero, who resigned in March. Plossner is an economics professor and former dean of the Business School at the University of Rochester.

Rejected

The House Appropriations Committee rejected an amendment to a bill that would have restricted the acceptance of Matricula Consular cards as a valid form of ID.

Cyber Savvy

In a recent survey, nearly 87% of consumers indicated that they felt they could recognize fraudulent e-mails, however, 61% failed to recognize a legitimate email and 67% could not identify a secure web site.

Construction

There were just over 7.5mm people employed in the construction industry in April, marking the 15th consecutive high water mark for the sector.

Board Members

Women hold 14.7% of Fortune 500 board seats in 2005, up from just under 10% in the prior decade. At that rate, it will take 70Y for women to reach equality with men.

Brand New

By the end of this month, banks will be able to hedge residential real estate exposure in 10 cities around the country in the derivatives market. This new tool will allow banks to hedge regional exposure to developers, contractors of others tied to the housing sector.