THE COST OF YOUR CORE FUNDING

by Steve Brown

You have heard us say many times that it is a banking tragedy that although a bank derives almost 70% of its value from deposits, most institutions spend more on cleaning supplies than on deposit research. Banks have Chief Credit Officers, Chief Lending Officers, loan production offices and loan committees, but very few resources are spent researching and managing the one instrument that makes them the most money - deposits. Here is a quiz. Would you rather have, a non-interest bearing retail checking account, a commercial money market account priced at 4% or a retail savings account priced at 2.6%? That is a fluffball question, right? The checking account not only comes to you interest free, but exhibits the lowest rate sensitivity. The question is of huge importance because as banks allocate resources for 2007, it is helpful to understand where value is derived in order to best employ resources. Creating marketing plans, pricing, tiering, fee setting and bundled packaging all revolve around how to enhance return to the bank. Now, let's get back to our question. The only problem is that retail checking takes up a lot of time in origination, processing, compliance and management. In fact, on an activity basis, a significant amount of a bank's overhead resources are devoted to retail checking. Retail savings, has the advantage of carrying higher average balances than retail checking, but is hamstrung by being more interest rate sensitive. Commercial money market accounts, on the other hand, suffer from being highly interest correlated (one of the highest in the bank), but have the advantage of attracting balances that are multiple times larger than either retail checking or savings. As a result, the fully allocated cost on commercial MMDA accounts is significantly lower than both checking and savings and is often times the account of choice for creating additional profit. Because of these costs, banks can increase the rate they pay on MMDAs and still be better off. The fully allocated costs for MMDAs are usually between 40bp and 110bp depending on the average size of accounts. Retail, by comparison, has a cost layer of between 200 and 750bp. Business checking is a whole other animal and, if managed right, can be the most profitable product in the financial services universe (depending on a bank's cost structure and if they pay interest on business checking (despite Reg. D)). Breaking it down one more layer, it is helpful to understand the difference between fixed and variable costs within your bank. The higher percentage of fixed costs, the higher level of marketing must be done for retail checking in order to build enough "bulk" to cover costs across the entire deposit platform. Once variable costs approach the fixed percentage, then greater resources can be devoted to profitable account lines. Given the flat yield curve and deposit competition, banks should consider devoting more resources to both profitability and deposit management. By better managing products and customers, banks can increase earnings in 2007, with the need for higher than average growth.

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BANK NEWS

Acquisition

First State Bancorp. ($2.6B, NM) will acquire the holding company of Heritage Bank ($451mm, CO) for about $72mm in cash, or 2.1x book.

Deposit Competition

Wachovia has announced they will roll out a remote deposit capture service that allows customers to make deposits through the internet. The new application eliminates the need for customers to install and maintain remote deposit software on customer office computers.

Expanding

BankAtlantic ($6.1B, FL) said it will open more than 20 branches in the Orlando, FL market in the next several years, as the bank plans to add 40 branches by mid-2008.

Purchasing Power

In an effort to capture more small business customers, US Bank rolls out its "Access Purchase" online application that allows its corporate customers to purchase discounted goods through a network of vendors such as Office Depot.