NO NEED TO BE STUBBORN

by Steve Brown

Donkeys are funny critters, notoriously stubborn and they tend to kick. While we have never been kicked by a donkey personally, we hear it hurts. The reason we bring this to your attention is because sometimes people need a good swift kick to remind them of opportunities. The same is true in banking, but before we get too far, we first spread around some hay for later consumption. Definitions vary, but most know that a correspondent bank is a bank that either directly serves as a depository for a community bank or helps increase access to a broader array of products and services. The correspondent's basic role is to provide products and services more economically or efficiently than a community bank could otherwise get directly. This is our primary business, so we also know a thing or two about it. Our discussion, however, will focus on compensating balances. In brief, compensating balances are a minimum level of excess balances a community bank will leave on account with a correspondent to compensate/pay for various products and services it has received. Community banks will typically utilize compensating balances to avoid paying "hard" charges when paying for services such as foreign exchange, payroll processing, IT, cash letters or consulting. Each month, charges are totaled up by the correspondent and an earnings credit is applied to the average balance in the account. To calculate the earnings credit, an earnings credit rate ("ECR") is required, which is the rate at which funds left in an account earn "interest" and from which fees are paid. There are no underlying investments related to the ECR Â– rather it is simply a rate to be applied to balances left in a given account. Expressed as a formula, the calculation is usually the ECR * average balance * days of month / 365. At many of the largest national correspondent banks, the ECR is often calculated as the 3 month T-Bill rate or another rate substantially below Federal Funds. Since we are owned by community banks, we pay our customers that leave compensating balances the monthly average gross rate on our PCBB "As Agent Fed Funds" program less 20bp (to cover monitoring, processing and transaction costs). Compared to many of the national bank programs, our higher ECR would have put an extra 93bp in a community bank's pocket so far in September (i.e. the mean spread between target Fed funds and the 3M T-Bill). Let's look at a specific example. Assume a community bank had purchased one of our quarterly private-label newsletters at a cost of $2,200. Assume that this expense was also not in the bank's budget for this year. In this example, the cost to cover using compensating balances is $2,200 / 3 months or $733.34 per month. Assuming a 4.55% ECR and a 31 day month, this bank would need to leave a daily compensating balance of $189,767.22 ($733.34 * 365 days / 31 day month / 4.55% ECR). In this example, the bank has still paid for the services rendered, but the cost does not show up as an expense, so it does not hit the efficiency ratio. Compensating balances are great for banks with a high efficiency ratio. In some states, there can also be a tax benefit. For example, banks paying taxes in states where NIM is considered gross revenue (i.e. WA, NM and others) can receive a substantial benefit by using compensating balances. For instance, assuming a 7.875% gross revenue tax rate (as in NM) and a 4.75% Fed Funds investment rate, a bank picks up roughly 41bp in value by using compensating balances to pay for services instead of paying hard dollars (i.e. 4.75% / (1-7.875%) = 5.156% - 4.75% Fed Funds investment rate = approximately 41bp in added value by using compensating balances instead. For these reasons and others, leaving compensating balances with PCBB can make significant sense. Stop being stubborn and let us show you the math the next time you purchase credit stress analysis, relationship profitability, customer newsletters, the loan pricing model, liability coach, interest rate risk review, outsourced ALM, brokered CDs, settlement, foreign exchange, wires, courier, core, item processing and a host of other products and services provided by us or by a 3rd party. Did we mention community banks earn the ECR on 100% of their balances (i.e. no FDIC reserves)?

BANK NEWS

Job Cuts

Bank of America said it would lay off 4,000 employees (2,500 in IL and 1,500 in MI) related to its purchase of LaSalle Bank.

CD Lawsuit

2 customers filed a lawsuit against BofA alleging that the bank improperly rolled over their CD investments at below market rates. The 9-month CD was reportedly renewed at 2.62% when BofA had a published rate of 3.35% and was also running an 11-month CD promotion at 4.89%.

More Branches Sold

First Tennessee Bank has sold all of its 34 branches outside of its home state to a group of banks. Purchasers included M&T Bank (13 branches in N. VA and MD), Sterling Bank (10 branches in TX), Fifth Third (9 branches in GA) and FMCB Holdings (2 branches in GA).

Name Change

Premier Commercial Bank Arizona has changed its name to Valley Capital Bank as part of an $11mm acquisition transaction completed earlier this month.