CDS FOR GOOD AND EVIL

by Steve Brown

One of the most maligned products in banking has been the brokered CD. In the name of full disclosure, we have a healthy business going in CD underwriting, so maybe we are slightly biased. However, we have this business not because banks issue CDs, but rather, we believe that when used properly, brokered CDs reduce risk.

The FDIC's recent proposal to increase premiums on banks with concentrations of brokered CDs is misguided. If you isolate just those banks that have failed, there are much higher correlations to earnings on loan concentrations, average loan size, lending class exposure and about a dozen other ratios than there are to brokered CD volume. In fact, if you want to look at just liabilities, the level of a bank's cost of funds explains almost 50% more of the failure than the amount of brokered CDs on the books. Regressions aside, consider that of the 314 banks that have failed since 1992, less than 40% even used brokered CDs. Further, only 8% had concentrations, as implied by the proposed FDIC excess premium levels.

Many banks have done (and are doing) a very good job of driving themselves out of business without using a dime of wholesale money. The last bank that failed in GA is a classic example of an institution that we pointed out as having problems back in 2007 (because they were running CD promotions at the top of the market at 5.75%). This type of high rate special is much more toxic than any damage that could be done with brokered CDs.

Banks fail because of what happens on the asset side of the balance sheet (that then hurts liquidity) rather than the funding side. To vilify brokered CDs is to have the cause and effect wrong. Bankers often use brokered CDs because it is the path of least resistance to fund runaway asset growth. Reckless asset activity and growth rates are things that DO cause many banks to go belly up.

In fairness, some banks are able to fund growth with heavy use of brokered deposits which is why the "evil" view of brokered CDs does have a basis in fact. These relatively few banks are being used to blacken the eye of brokered deposits. Time has shown that excessive growth rates in risky assets almost always have outcomes that are not pleasant. As we have said before, bankers should figure out what their core deposit growth should be and then set asset growth levels - the complete opposite of what is normally done.

Of all the multiple factors in banking, funding cost is the hardest to control. It takes understanding, discipline, training and planning to achieve a solid core funding base. Show us a bank that paid attention to their funding base in 2005 and we will show you a bank that also paid attention to their reserve levels, asset quality, concentrations and overhead costs. Most banks that had a cost of funds below average in 2005, had above average earnings in 2008. The reality is that smart bankers pay attention to funding cost first and foremost.

Through our Liability Coach product, we've worked with many bank clients that use brokered CDs (in excess of 10% of total deposits) which have been able to prove to their examiners that they are using this funding to enhance the safety and soundness of their banks. These banks have clear and well-thought out funding plans, can show detailed rate surveys and market analysis packages and have the analytical data to back up their claims. If used correctly, wholesale funding is a risk-minimizing tool, as it can help protect and lower the cost of the deposit base. For every bank that misuses brokered CDs, there are 5 that use wholesale funds correctly. Unfortunately, good stories do not grab the headlines.

BANK NEWS

That's Low

A worsening credit situation overseas has led the Bank of England to cut its benchmark interest rate by 50bp (down to 1.50%). The rate is now the lowest since the central bank was founded in 1694 (314Ys ago). Now that is a record we would not like to see again in our lifetimes.

Worst Ever

The ABA reported yesterday that late payments on a composite ratio of consumer loan categories jumped to 2.90% in the 3Q, up from 2.68% in the 2Q (an 8% increase). This is an all time high and is expected to get worse as unemployment rises in coming quarters.

Business

ccording to a survey by Greenwich Associates, 50% of small business and 40% of mid-sized companies are either actively searching or receptive to switching banks. The survey cited that in previous years, businesses were driven to change banks due to price and service. Presently, the most common reasons for switching are related to obtaining more flexible credit terms and conditions, a lack of commitment to their business and more reliable access to credit.

Money Market

The FRB has expanded the scope of institutions that can invest in the $600B Money Market Investor Funding facility. This list now includes money market funds managed by banks, municipalities, states, trust companies, investment consultants and insurance firms.

Apartments

Rents dropped 0.4% in the 4Q (up only 2.2% from a year prior), as vacancy rates soared to a 4Y high at 6.6%. Rents dropped in 54 of 79 markets and vacancies in 66 of 79.