MARGINAL VS. EFFECTIVE COST OF FUNDS REVISITED

by Steve Brown

Always one to stir a debate, we bring up again the controversial topic of is it better to think in terms of your effective cost of funds instead of your marginal cost of funds when managing asset production? Our argument has always been squarely on the side that using an effective cost of funds is better for deciding if you want to make that next loan.

To us, money is fungible on the balance sheet so that if you enjoy a strong DDA base, then that set of low cost funds should be spread across the whole institution both now and in the future. Updating your effective cost of funds weekly or monthly, keeps all decisions equal despite where rates move in any one day.

The counter argument is since you already have a fixed set of liabilities, the next loan you make is on the margin, so your funding should also be on the margin. This logic leads to banks utilizing the FHLB, brokered funds or other mechanisms to match fund loans and using the cost of those marginal borrowings in their loan pricing calculations. For banks undertaking investment leverage strategies, the same calculations are in play.

So here is our question - If you are in the marginal funding camp, what are you doing now? A bank's marginal cost of funds on the short-term side is between 25bp and 55bp. In order to enhance performance, banks should be moving to a net borrowed position (as we have seen many banks do during 2Q) in order to reduce their cost of funds and help margins. In this particular case, the next asset on the balance sheet should therefore be funded not at 2.01% (the average effective cost of funds as of 2Q for community banks), but at 25bp. Oddly, as we called around, it appears that many banks that were once in the marginal cost camp now appear not to be passing on the marginal cost of funds - call it the "higher than marginal or effective cost of funds camp.'

To be intellectually honest, bankers really can't have it both ways. Both are good arguments, but we believe the current rate environment points out why utilizing a bank's average funding cost is a more accurate way to calculate the profitability of a loan or investment purchase. No matter where rates go, a bank is either hamstrung by its liability base or benefited and all in the bank should share. More to the point, funding is a separate activity entirely than asset liability management and should be treated as such.

The best performing banks in the country hedge their loans through the focus on non-interest bearing DDA accounts. After that a bank can be multiple times more efficient at utilizing our BLP Program to turn fixed rate assets into floating rate assets without accounting issues instead of looking to match fund. Match funding in the wholesale market not only comes at a cost, but also make banks less motivated to devote resources to building a core funding base. By utilizing a marginal cost of funds approach, banks are motivating their staff for exactly the wrong behavior. When rates are higher than their current cost of funds, CFOs end up penalizing loan production thereby making loans less attractive. When rates are lower, banks seek the ease of wholesale funding and are less motivated to build non-interest DDA balances.

If your bank is still stuck on utilizing marginal cost of funds and finance is passing on that 25bp rate, so be it, at least management is logically consistent. However, if not, it is time to take another look at your methodology.

UPCOMING TACTICAL WORKSHOPS

Our next Tactical Workshop on regional loan quality, pricing and deposit structuring is coming up in Seattle on August 19th. After that, we look to hold one in Chicago October 8th and planning for one in Virginia in early November. For more information, contact us and we will get you registered.

BANK NEWS

Ugly Situation

The American Bankruptcy Institute reports consumer bankruptcies jumped 34.3% in July, compared to the same period last year, as high debt loads and increased unemployment weighed on consumers.

Sector Analysis

A new survey of real estate investors by PricewaterhouseCoopers projects that over the next 12 months, apartment values will fall 7%, regional malls will drop 8.5%, warehouses will drop 8.2% and office values will decline 11.4%. Meanwhile, cities expected to be hit the hardest were Dallas (-17%), San Diego (-16%), Atlanta (-13.5%) and Houston (-12.5%).

Bank Fail Peak

While we have been averaging 5 to 7 bank closures per week the past few weeks, it is interesting to note that the high was set in 1989 when 60 banks were closed in one week.

Housing

Homeownership in the US reached nearly 70% in 2004, but has since fallen to 67.4% as of the 2Q of 2009. Interestingly, about 57% of housing units that are added to the market become rentals these days.

Supply

A study by ZipRealty finds the supply of homes available for sale in major metropolitan areas fell 2.5% in July compared to June