GET RID OF YOUR 3-MONTH CDS TO INCREASE WINNINGS

by Steve Brown

Poor Alex White. In 1995, White matched all 6 numbers in a major lottery. The problem was that instead of winning the $27mm pot himself, he had to split it with 132 other lucky winners for a mere $206k payout - talk about disappointment. The incident highlights that fact that while the odds are the same for matching all 6 lottery numbers (approximately 175mm to 1 for a common 46 number game), the expected winnings may not be. This is why serious students of the lottery pick numbers above 31 (people love to pick their birthdays and 7, 14 and 18 are by far the most popular numbers), pick numbers around the outside of the grid (most people gravitate towards the center) and pick consecutive number strings. Use this strategy and while your odds of winning will not improve, the expected value of your winnings almost double.

In similar fashion, many banks choose to spend more energy on their CD issuance than their money market and interest bearing checking accounts. We bring this up as it was just last week that the average money market rate at banks and the average 3-month CD rate at banks were finally the same at around 45bp (after years of being apart). Normally, banks post a rate on their 3-month CDs that is about 25bp more than their money market account. The logic is that since CDs have a term on them, they are more valuable than a money market account.

Ironically, for banks that do the math, it is the money market account that is more valuable. As veteran deposit officers will tell you, it is not so much the maturity that is important, but interest rate sensitivity. While the calculation of interest rate sensitivity has to do with finding both the duration and positive convexity for each product (something called "deposit product gamma"), simplistically, you want the most interest rate sensitivity when rates go up (remember we are talking a liability here) and the least when rates fall.

Similar to the expected lottery winning calculations that rely on more than just figuring the odds, smart deposit managers know that building value is a function of gathering liabilities that exhibit the least sensitivity to interest rates movement. The average money market account at community banks, for example, has duration higher than a 3-month CD and multiple times the convexity. The lower the rate on the money market account, the less interest rate sensitive those account holders are and the greater the ability a bank has to lag pricing when interest rates are going up (and drop them quickly when rates fall). As such, the money market account deserves much greater attention than CD structuring.

Of course, the problem comes in when banks try to pay too much for their money market funds. In this market, 1.20% seems to be an inflection point on the demand curve. Once banks post above that for money market rates, they end up destroying value by dramatically increasing interest rate sensitivity and thereby decreasing the net value of those deposits.

At our next Tactical workshop for the Mid-west market coming up on October 8th at the W Hotel in Chicago we will be talking in-depth about funding strategies, deposit structuring, liability pricing and contingency liquidity planning. If you can attend - great, as you will learn some valuable techniques. If you can't attend, know that most banks do themselves a disservice by offering a 3-month CD. The reality is the 3-month CD is far less valuable and should be priced below money market offerings. Should this occur, banks end up eroding the value of the money market account by drawing funds into 3-month CDs that have a shorter duration and less convexity.

The better move is to get rid of your 3-month CD offering altogether (start your CD ladder at the 6 or 9 month mark) as to not to invite comparison. In this manner, both retail and business customers will place more emphasis on the money market account's flexibility, which should result in lower rates and greater net value to the bank for that product. Do this the right way and you may find that like your expected lottery winnings, your money market account value will almost double.

BANK NEWS

3 Bank Closures (92 YTD)

On Friday, the FDIC closed banks the following: [1] Corus Bank ($7B, IL, TX Ratio 3,033%) bought by MB Financial Bank ($8.4B, IL). MB will assume all deposits, 14 branches and $3B of cash and securities assets (assets look to be sold by the FDIC). [2] Brickwell Community Bank ($72mm, MN, TX Ratio 935%) bought by CorTrust Bank ($542mm, SD). CorTrust will acquire 1 branch, all deposits (for a premium of 0.10%) and essentially all of the assets. [3] Venture Bank ($970mm, WA, TX Ratio 257%) bought by First-Citizens Bank & Trust ($14.6B, NC). First-Citizens will acquire 18 branches, all of the deposits and about $874mm in assets.

No More Guarantee

Bankers should take note that the government guarantee on money market funds will end this week (Sep. 18). Banks should consider having a marketing program ready to take advantage that change if at all possible.

Land Sales

Some banks are reporting success in selling OREO land in areas hit quite hard during the downturn. Pricing is indicated at 30 cents on the dollar to 50 cents of original appraised value depending on the area.