Going Gaga over Funding Costs

by Steve Brown

We must admit to liking the music of Lady Gaga. We realize it is not a normal topic for a banking newsletter, but giving respect where it's due should reach across all industries. Lady Gaga is interesting because she creates art with an eye on the past (recording Broadway Golden Age hits like Gershwin songs with Tony Bennett) or looking well into the future (with an upcoming project to be the first to record a song in outer space). Her plan is to record a music video with her glam squad representing art, music, fashion and technology aboard a Virgin Galactic space flight in 2015.

Banks too, are trying to plan for the future while keeping an eye on the past. We have come across a number of instances where banks are using tools like FHLB advances to match fund longer-term assets. The logic goes that longer-term interest rates are still historically low so it makes sense to lock in funding costs to match seemingly ever-longer assets. The logic continues that the only place interest rates can go is up or maybe sideways first and then up, so this is logical preparation.

It is true that long-term rates are low, historically speaking. However, it is also true that short-term rates are very low and a lot lower than long-term rates--about 300bps lower. In managing funding costs, banks need to take advantage of everything they can so finding the least expensive method is important both for today and over time. The idea of locking in a long-term FHLB advance may seem smart in the face of increasing interest rates, but it also adds certain risks. We just had a rehearsal of what rising rates might look like over the summer in fact, as the market anticipated a tapering of quantitative easing (QE3) purchases, causing longer-term interest rates to jump 100bps.

To get a handle on all of this and consider options, we create a hypothetical bank who acted to lock in funding costs in the face of the news of the impending QE3 taper. The bank took out a 5Y FHLB advance at 2.07%. When 5Y Treasuries briefly touched 2.00%, this looked like a decent move. The risk piece, however, is that this level is still higher than the 10Y average of interest bearing deposit (IBD) cost of funds for over 50% of the banks in the country. Furthermore, 2.07% is over 100bps higher than IBD cost of funds of 90% of the banks today. Maybe this tactic would look good if rates had truly shot up instantly, but instead rates have once again dropped significantly. Further, with Janet Yellen moving through confirmation to be the next Fed Chair, it appears rates could remain low for some time to come.

Given that loan and other asset yields are under pressure, how can a bank handle this? Does it make sense to try to anticipate rate movement? At this point, with the power of hindsight, one could say our example bank could have waited, but how were they to know and they do need to manage risk after all. To be sure, for many banks it is the least favorite of assignments in any bank to make short and long-term interest rate projections for the year ahead for ALCO committee, because basically no one knows and most predictions are wrong. Few banks took advantage of momentarily higher rates to purchase Treasuries or bullets this past summer either, as the common knowledge dictated rates would keep moving higher once they got going.

Bankers know that eventually interest rates will move higher, but no one knows when so extending funding now can reduce earnings in a very tough market. Instead of using FHLB advances to bluntly handle interest rate risk, a less expensive and more focused way is through hedging tools and by instilling a focused effort on reducing funding costs over time. Most banks remain quite liquid in any case, so beyond the interest rate risk, be careful to review all of your options. Then, spend time properly warming up before singing this song too soon to avoid having your voice crack when you belt out the best one.

BANK NEWS

Competition

An Accenture report finds people get 34% of traditional banking services (CDs, savings accounts, checking accounts, money market accounts, personal and auto loans) from institutions other than their primary bank.

Wild West

Murky rules and harsh penalties related to the SEC's 180 page memo (allowing open solicitation of investors for companies seeking capital) are key reasons many companies are still treading very carefully when raising capital online. Multiple legal disclaimers, complexity, pre-approval and other factors are all issues that still need to be ironed out before wider acceptance occurs.

Mobility

Accenture reports the number of people using mobile banking has jumped to 32% in 2013 vs. 21% last year.

Tapering

JPMorgan economists now expect the Fed will begin tapering (removing QE) in Jan and be done by Sep of 2014.

Weakness

The biggest trading partner of the US, the European Union has reported annualized quarterly growth of an anemic 0.4%, given weak prices and high unemployment. Strength is needed to support US sales abroad.

Crisis

The Government Accountability Office (GAO) released a report on the financial crisis, stating extraordinary measures taken stabilized the US financial system and halted "the downward economic spiral."

Child Loans

Studies find the main reasons parents or relatives will lend money to children is to get married (25%), for education (24%), purchase a major item (23%), mortgage deposit/payments/rent (22%) and paying off debts (22%).

TBTF

The top 15 institutions from 12/31/2006 through 2Q 2013 have grown by 55%. Of note, Wells Fargo has grown 199%, JPMorgan is up 81% and Bank of America has grown 45%.