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PERSPECTIVE/ BY ROBERT E. KAFAFIAN

Managing Spreads Through Funds-Transfer Pricing



Mr. Kafafian is the president and chief executive of The Kafafian Group, Inc. a community bank consulting firm in Parsippany, N.J.

Today's economic environment is challenging community financial institutions to actively manage yields, rates, spreads, and resulting net interest margins.

Historically low interest rates that have been gradually rising over the past two years, a flat or even inverted yield curve, the continued commoditization of spread-based products, and a leveling off of deposit growth only compound this challenge.

In addition, 80% of community banks' revenue continues to be generated from spread-based products, versus 20% from fee-based products. This

emphasizes the need to proactively manage spreads and net interest margins at a drilled-down level of detail. Drilled-down, in this case, means at the line-of-business, organizational-unit, product, officer-portfolio, and/or customer-relationship level.

It is critical to develop funds-transfer pricing capabilities to manage this process. Funds-transfer pricing is the art and/or science of crediting

fund providers and charging fund users, while taking into consideration various maturity characteristics and risk factors.

Today's performance-measurement systems have come a long way from the archaic methodologies, broad assumptions, and systems limitations of 20 years ago and make precise funds-transfer pricing measurements and detailed trend analysis — which products and services are making you money, and which ones aren't — possible.

Historically, financial institutions have utilized the following funds-transfer pricing methodologies: single pool/rate matching, specific matching, multiple pool/rate matching, and matched term or coterminal transfer pricing.

The preferred and most accurate methodology in use today is matched maturity, which prices individual customer accounts to market-driven indexes, such as the Treasury yield curve, the Federal Home Loan Bank advance curve, a swap curve, or the London interbank office rate-based curve, for example.

Origination, maturity, and repricing characteristics from loan and deposit application systems are loaded into a database where funds-transfer charges and credits are determined. The resulting roll-ups highlight three parts of a bank's spread — an asset spread, a liability spread, and a treasury or asset/liability mismatch spread.

Funds-transfer pricing represents the value of money for a product, such as an adjustable-rate loan, on the date it is originated or has the opportunity to reprice. Therefore, the asset spread consists of each customer account's interest yield minus the funds-transfer price, which is

based on maturity characteristics and relative risk.

The liability spread consists of each customer account's interest rate, which is subtracted from the funds-transfer price. The maturity gap is the mismatch that results from the difference between the asset and liability sides of the balance sheet. For example, if the balance sheet of a financial institution were perfectly matched, the maturity gap would be zero.

Using peer-group data from our own clients, my colleagues and I have identified certain industry trends. It is important to note, for example, that despite the blurring of the lines distinguishing banks from thrifts, there are still differences in the way commercial banks and thrifts operate — and how they perform.

Consumer loans are not as profitable as commercial products, even though the spreads are similar. This is due to the cost of servicing consumer products and their smaller average balances.

In addition, while spreads are critically important, if operating costs are not efficiently managed, bottom-line performance will suffer. The right combination of spread, fee income, and operating cost management are necessary to understand true performance.

Other key observations:

- It is clear that asset spreads have declined over the past year in every product category, with the exception of thrifts commercial and industrial loans. This is most likely the result of the current yield curve environment and increased competition for loan volume. With regard to the increase in thrift commercial and industrial loan spreads, this is most likely the result of thrifts pricing up to the market, meaning they have been less inclined to offer low entry-level rates. Generally speaking, banks and thrifts are chasing the same lending opportunities in a rising rate environment, and the competitive nature has narrowed spreads.

- All bank liability-product spreads have increased over the past year, as

the Federal Reserve Board has raised rates, allowing for wider spreads as deposit pricing has lagged the market. This is particularly and most obviously the case with non-interest bearing demand deposit accounts, the ultimate fixed-rate product. Thrifts have not enjoyed the same increase in interest-earning and money market deposits, largely because the rates they paid exceeded the banks' by 21 and 52 basis points, respectively.

- Consumer loans do not perform at the same pretax levels as commercial products, even though the banks' spreads are relatively similar. This is due to the increased cost of servicing consumer products and their smaller average balances. Conversely, the thrift consumer loan spreads are approximately 100 basis points lower than commercial products, due to a larger dependence on home equity products and the frequency of entry-level promotions on these products.

- Residential mortgage products appear to be sandwiched between commercial and consumer loans in bottom-line performance. This is achieved with lower spreads and lower operating costs. The thrifts' spreads are 71 basis points less than banks', largely due to a yield differential of 54 basis points in favor of the banks.

- Banks make substantially more money on non-interest bearing demand accounts than thrifts do. This highlights the importance of the average balance size per account, and the volume of commercial checking customers. The average balance of a bank account is over \$7,000, while the thrift average is below \$3,500.

- Time deposits have similar spreads for both banks and thrifts. These spreads, however, are substantially below those of every other loan and deposit product. This illustrates why customers whose only product at a particular bank is a certificate of deposit are not the most desirable.

The important takeaway here is that banks and thrifts must proactively manage spreads, margins, and bottom-line performance at detailed levels. Funds-transfer pricing and performance-measurement systems can provide banks and thrifts with meaningful analysis and can help chart courses of action for selling and servicing products, building relationships, and providing adequate profitability and performance. ■