對外經濟貿易大學

Chapter 6

Managing Liabilities

Composition of Bank Liabilities

- Different types of liabilities
  - Interest-bearing and non-interest-bearing
  - Transaction accounts:
    - Low explicit interest rates
    - High non-interest processing costs
  - Other accounts:
    - Limited check writing capabilities
    - Higher rates
  - Liabilities with long-term fixed maturities
    - Highest interest rates
    - Lowest non-interest transaction

Prior to 1960

- Banks relied on standardized demand and savings deposits as their primary source of funds.
- Gov't determined allowable interest rates, and all banks paid the maximum.
- Banks compete for funds only by differentiating the quality of service and paying implicit interest.
- Primary strategy: office and branches.

From 1961 on

- 1961: Citibank, CD
- Market rate fell below the ceiling.
- Other market rate instruments emerged.
- Today, virtually all bank liabilities are free of regulatory restrictions on allowable rates, maturities, and minimum denominations.
  - Banks can offer any deposit product.
  - Price competition is the dominant consideration.

Problems created by the freedom

- Customers have become much more rate conscious: interest elastic.
- Customers prefer shorter-term deposits strongly: lower interest rate risk.
  - Liabilities become more rate sensitive
  - Pricing assets becomes more difficult

Recent trends

- For all banks (compared with 1992):
  - Fewer total deposits, transaction accounts, and core retail deposits
  - More time deposits (CDs) and equity.
- Large banks:
  - Fewer transactions accounts, large time deposits and equity
  - More MMDAs, foreign deposits, and other borrowings

Core deposits

- They are stable deposits that customers are less likely to move when interest rates on competing investments rise.
  - Not rate sensitive as large-denomination purchased (volatile) liabilities.
  - Influenced more by location, availability, price of services.
  - For large banks, core deposits/total assets: 51%→42% (from 1992 to 2001)

Volatile liabilities

- Purchased funds from rate-sensitive investors
- They will move their funds
  - If other institutions pay higher rates
  - If it is rumored that the bank has financial difficulties
- With more such liabilities (34% v.s. 15%), larger banks are paying market rates on a greater proportion, with less customer loyalty and thus greater liquidity risk.

Cost of funds

- Competitive pressures pushed the average cost of funds between small banks and large banks to be comparable.
- While small banks' overall costs of interest-bearing deposits was 69 basis points higher, they paid lower rates on transaction costs and on hot money sources.
- Small banks' overall cost of interest-bearing funds was 45 bp higher than large banks.

Small denomination liabilities

- Under $100,000 (v.s. multiples of $1 million)
  - Normally held by individual investors
  - Not actively trade in the secondary market.
- Transactions accounts
  - Demand deposits
  - Interest-checking
    - Negotiable orders of withdrawal, NOWs
    - Automatic transfers from savings, ATS
  - Money market deposit accounts, MMDA
- Banks differentiate between deposits in the number of checks permitted, minimum denomination required, and the interest paid.

Service charges

- For many years banks priced check-handling services below cost, because banks paid below-market rates on most deposits.
- This low interest subsidy implicitly covered the losses. 20% customers subsidize 80%.
- Because banks now pay market rates on deposits, they want all customers to pay at least what the services cost.
- Many banks have unbundled services and price each separately.

Large denomination liabilities

- Funds purchased in the money markets.
- Denominated in $1 million multiples.
- Because customers move their investments on the basis of small rate differentials, these funds are labeled “hot money”, volatile liabilities, or short-term noncore funding.
- Jumbo CDs (CDs over $100,000)
  Federal Funds Purchased
  Security Repurchase Agreements

Jumbo CDs

- Brokered deposits
  - Indirectly sold through dealers and brokers
- Variable-rate CDs
  - renegotiated every three months
- Callable CDs
  - Long-term. Worry about rate falling
- Zero coupon CDs
  - Sold at a steep discount
- Stock market indexed CDs
  - yields linked to a stock market index

Federal funds purchased

- Federal funds: unsecured short-term loans that are settled in immediately available funds.
- They encompass transactions outside the arena of bank reserve trading by including any participant that holds large balances at FRBs or collected liabilities at depository institutions.
- Most transactions are overnight loans.
- Federal funds rate is a key target variable for the monetary policy.

Security repurchase agreements

- RPs (or repos) are short-term loans secured by gov't securities that are settled in immediately available funds.
- They are virtually identical to federal funds in function and form except they are collateralized.
- Technically, the loans embody a sale of securities with a simultaneous agreement to buy them back later (often the next day) at a fixed price plus accrued interest.

Funding costs and banking risk

- Banks face two fundamental problems in managing their liabilities
  - Uncertainty over what rates they must pay to retain and attract funds.
  - Uncertainty over the likelihood that customers will withdraw their money regardless of rates.
- The basic fear is that they will be vulnerable to a liquidity crisis arising from unanticipated deposit withdrawals.

Rates regulation and liquidity

- When deposits rates were regulated and banks paid the maximum rates allowed, deposits were relatively stable and liquidity was less a problem.
- Interest rate deregulation and bank competition have since increased depositors' rate awareness so that many individuals and firms move funds to institutions paying the highest rates.
- Customer loyalty is closely tied to deposit size and the quality of bank service.

Funding Costs and Banking Risk

- Funding Sources and Interest Rate Risk
- Funding Sources and Liquidity Risk
- Funding Sources and Credit Risk
- Funding Sources and Bank Safety

Interest rate risk

- More borrowed funds with shorter maturity
- Increased rate sensitivity of liabilities
- Banks: two measures
  - Pay premiums (incl. attracting core deposits)
  - Reprice liabilities more frequently

Liquidity risk

- Customer-driven
- Competition-driven
- What can banks do?
  - Monitor potential deposit outflows
  - Periodically contact large depositors
  - Understand (and change) the interest elasticity
  - Build a liquidity buffer

Credit risk & bank safety

- Asset quality is forced to be reduced.
  - Riskier loans
  - More important for small banks
- Lowered traditional earnings
  - Slows capital growth and increases leverage ratio
  - Borrowing costs increase

Federal deposit insurance

- The Banking Act of 1933
- Insurance funds
  - Funded via premiums paid by member banks
- Objectives of deposit insurance
  - Prevent liquidity crises
  - Protect depositors of modest means

Handling Problem Banks

- FDIC has five basic options:
  - Purchase and assumption
  - Open bank assistance
  - Insured deposit assumption or transfer
  - Bridge bank
  - Payout option
- Minimize the costs
- Payouts: small banks
- Large banks: purchase and assumption
  - Going concern value

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