CSBS

Wholesale Funds: Source of Growth or Regulatory Scrutiny?

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By Thomas F. Siems, Ph.D., CSBS Senior Economist

When community banks utilize wholesale funds, is it to support loan growth or manage liquidity risk? The 2019 CSBS National Survey of Community Banks dove into wholesale funding strategies and identified seven possible alternatives to core deposits.

Based on responses from 571 community banks, Table 1 shows the most frequently used wholesale funding source (ranked using the column heading "use and no change") was public deposits (73%), followed by Federal Home Loan Bank (FHLB) advances (65%) and then a sharp drop to 42% for federal funds purchased/repurchase agreements.

Table 1: Wholesale Funding Sources (percent responding)

	Use and no change	Use and increase	Use but will drop	No use and no plan to use	No use but plan to use
Public Deposits	73	9	3	13	2
FHLB Advances	65	6	3	20	6
Fed Funds/Repos	42	2	2	48	7
Brokered Deposits	35	4	6	48	7
Other Borrowed Money	27	2	2	65	5
Listing Service Deposits	25	2	3	62	8
Discount Window	16	1	1	77	6

By matching individual bank survey scores with financial performance data on bank call reports, some usage patterns emerge for brokered deposits and FHLB advances. Larger banks (greater than $500 million in total assets) more frequently report using brokered deposits (48% versus 35% for all banks) and FHLB advances (77% versus 65% for all banks). Faster growing banks, based on total asset growth of more than 8% over the last year, more frequently report using brokered deposits (49% versus 35% for all banks). There is no apparent association between profitability and the use of any source of wholesale funds.

The use of wholesale funds could be related to impediments to attracting and maintaining core deposits. For example, if competition is an impediment, then wholesale funds could substitute for core deposits when profitable loan opportunities exist. However, none of the impediments in the survey (i.e., market competition, national rate cap, depopulation, capital constraints, or other changes in market demographics), were related to the use of wholesale funding.

Wholesale funding could also be related to a strategy where loan growth is favored over core deposit growth, especially if the bank is capital constrained. Yet, the results show the opposite, perhaps because rapid increases in the loan-to-core deposit ratio might attract regulatory scrutiny.

Chart 1 shows that banks that use brokered deposits and FHLB advances are more likely to prioritize a core deposit growth strategy over a loan growth strategy. The survey indicates that 35% of banks that use brokered funds (blue bars in Chart 1) report that they “usually” or “always” prioritize core deposit growth over loan growth versus 27% for all banks. Similarly, but much weaker for FHLB advances, 29% of the banks that currently use FHLB advances “usually” or “always” prioritize core deposit growth over loan growth compared to 27% overall.

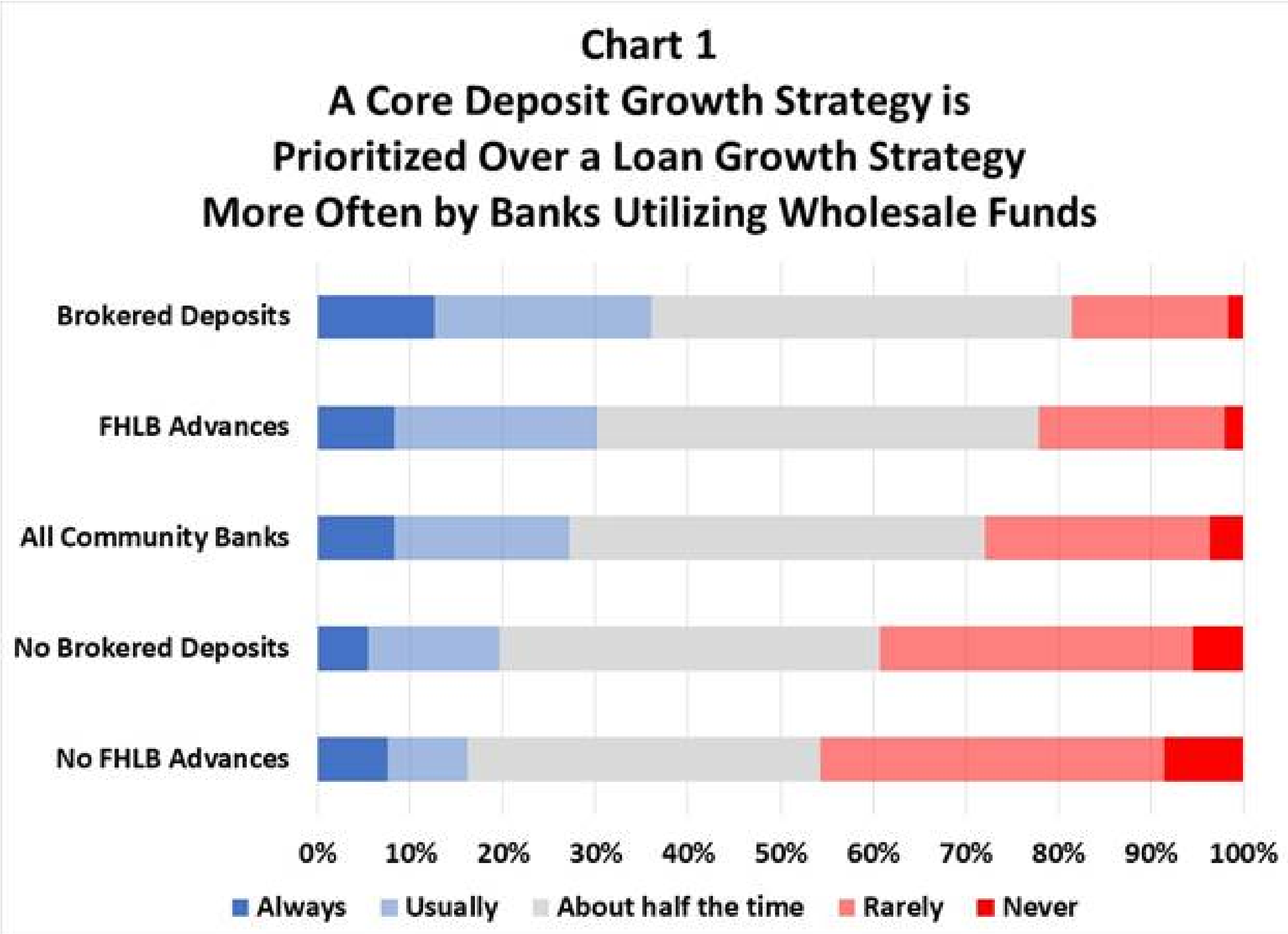
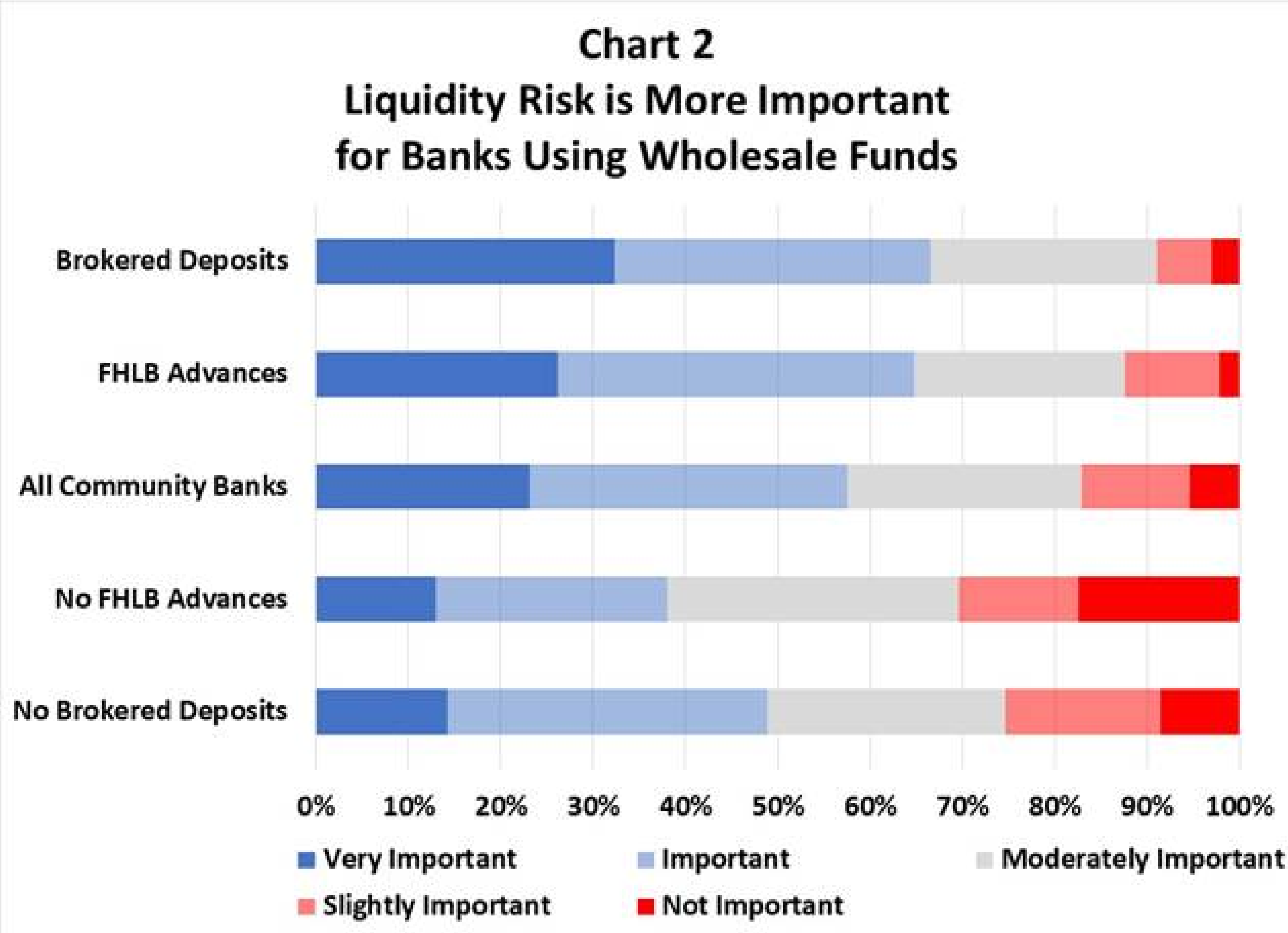
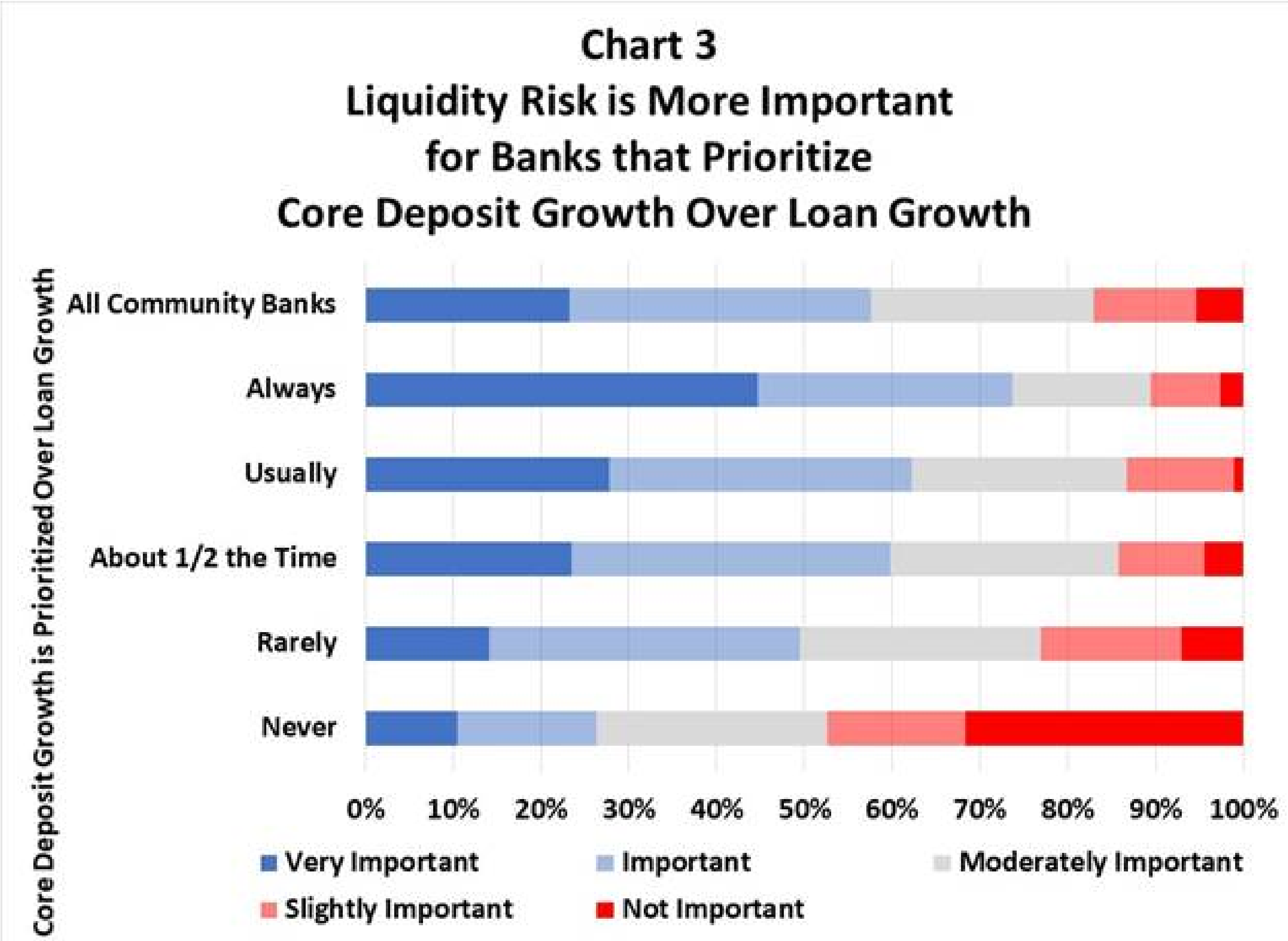


Chart 1 also shows that banks that do not use brokered funds or FHLB advances (red bars) are more likely to favor a loan growth strategy over a core deposit growth strategy. The survey shows that 39% of banks not using brokered funds report that they “never” or “rarely” prioritize core deposit growth over loan growth compared to 27% overall; for FHLB advances, the respective percentages are 46% and 27%.

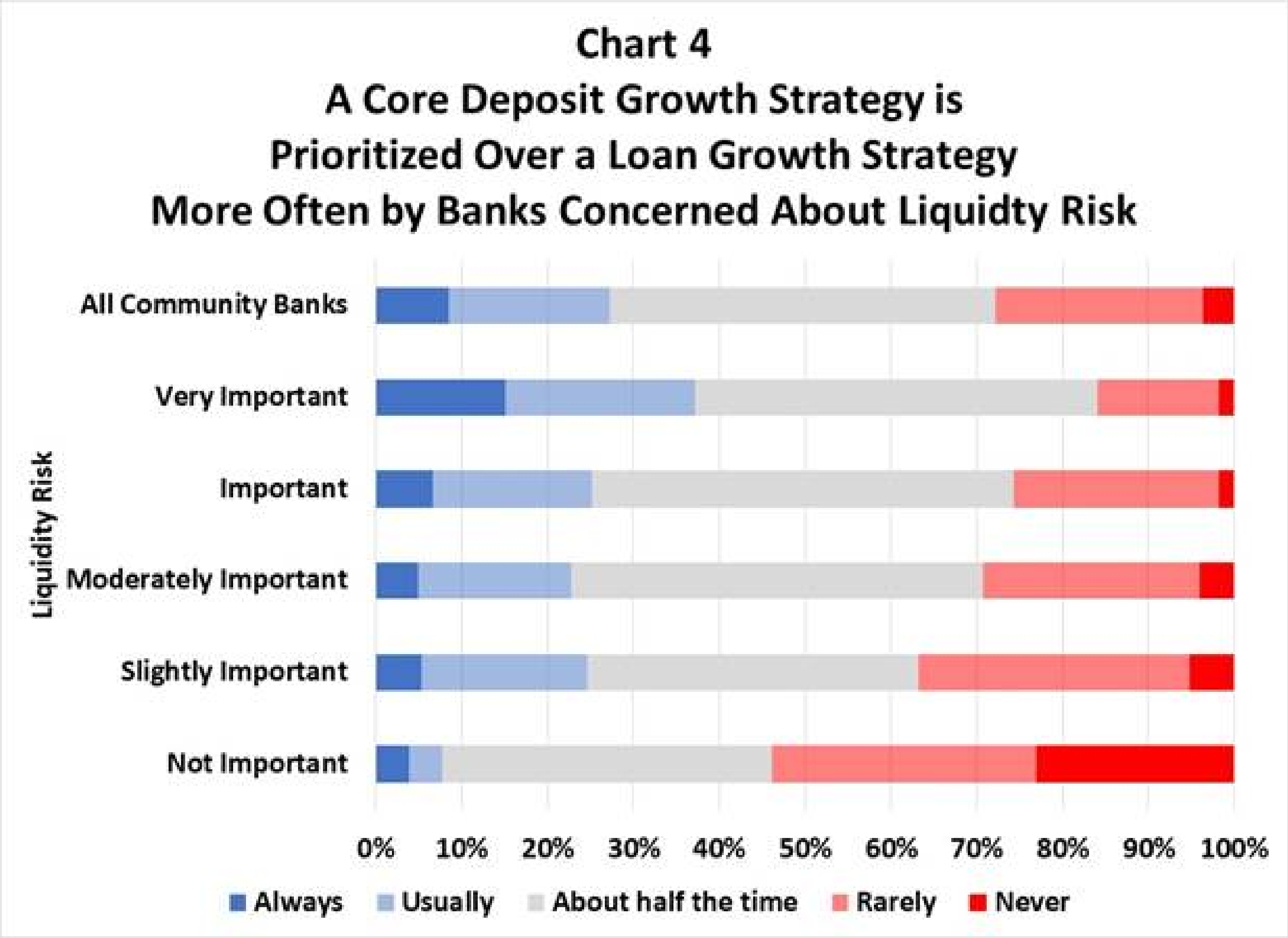
This outcome may reflect a perception that the use of borrowed funds increases liquidity risk and the chance of a regulatory response. If so, growth of core deposits should reduce liquidity risk. The survey responses shown in **Chart 2** appear to support this conjecture. Banks that use brokered deposits or FHLB advances more frequently report liquidity risk as a “very important” or “important” risk facing their bank today (blue bars). Indeed, 66% of banks that use brokered deposits report that liquidity risk is “very important” or “important” versus 57% overall; the respective percentages for FHLB advances are 64% and 57%.



Another way to look at this association is to see whether the choice of a core deposit growth strategy is directly related to a high concern over liquidity risk, where bankers ranked how important liquidity risk is to their business from “very important” (23%) to “not important” (5%), as shown in **Chart 3**. For banks that “always” pursue a core deposit growth strategy, 74% see liquidity risk as “very important” or “important” (blue bars), compared to 57% for all community banks, and just 27% for banks that “never” pursue a core deposit growth strategy.



Moreover, as shown in **Chart 4**, 37% of banks reporting that liquidity risk was "very important" or "important" reported they "always" or "usually" pursue a core deposit growth strategy (blue bars) compared to 27% overall. This result is consistent with a more risk-focused core deposit growth strategy.



In conclusion, only two wholesale sources of funding, brokered deposits and Federal Home Loan Bank advances, showed any relation with a core deposit growth strategy. The use of borrowed funds to support a core deposit growth strategy over a loan growth strategy appears to be explained by the importance that banks place on liquidity risk. Bankers concerned more about liquidity risk more frequently report using both brokered deposits and FHLB advances. Banks using wholesale funds may be hedging this risk by emphasizing core deposit growth to maintain a desired balance between core and wholesale deposits.

This blog is the third post based on research from a recent CSBS working paper (co-authored with William C. Dunkelberg, chief economist at the National Federation for Independent Business, and Jonathan A. Scott, professor at Temple University). In the first post, community bank impediments to attracting and retaining core deposits was examined. In the second post, we explored factors driving banks to follow a core deposit growth strategy versus those that pursue a loan growth strategy.

CSBS
202.296.2840
newsroom@csbs.org
1129 20th Street, N.W., 9th Floor, Washington, DC 20036