

The Decline in Core Deposits: What Can Banks Do?

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INTRODUCTION

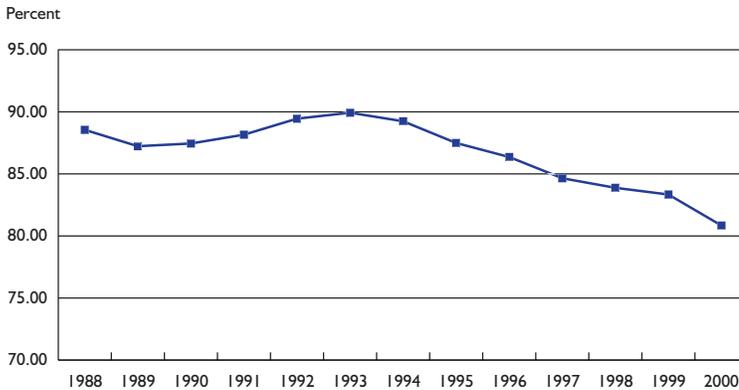
Growth in traditional deposit funding sources has stagnated at many banks in recent years and has largely failed to keep up with the growth in bank assets. In response to these trends, banks have had to supplement traditional funding sources with a variety of new, but potentially less stable and more expensive, funding instruments. In addition, banks have had to take other significant steps, including cutting back on their holdings of cash and securities and selling or securitizing parts of their loan portfolio. All of these steps are increasing the challenges that banks face in maintaining sound and profitable operations. From the public's standpoint, an even more pressing concern may be whether funding problems will keep banks from meeting the credit needs of their customers and communities. This article, consequently, will examine recent bank funding trends and their effect on community banks in the Kansas City Federal Reserve District.

A number of community bankers, in particular, have described recent funding shortfalls as a "crisis" in the making.¹ These concerns may have eased somewhat over the past few months in response to weaker loan demand, falling interest rates, and increased liquidity in the financial system. However, many community bankers believe that funding will be a persistent, long-term problem. In fact, a major fear of these bankers is that funding difficulties will eventually force them to curtail lending to small businesses, farmers, and other local customers—many of whom may have few other places to turn to for their borrowing needs.

Chart 1

Core Funding to Total Liabilities

Community Banks in Tenth District States



Source: Bank Reports of Condition and Income.

A notable portion of the bankers responding to our 2001 Tenth District Bankers' Survey further voiced such concerns.² Among their specific comments were: "The deposit base is shifting away from community banks," "The biggest problem for our bank is how we will fund ourselves in the future," and "Core deposit growth is not possible in small communities." Furthermore, in a survey question about the challenges bankers might face over the next five years, over 50 percent of the bankers thought that "maintaining and attracting retail deposits" would be a "significant problem," and another 35 percent felt that it would be a "moderate problem."

Not all signs, though, indicate that funding is such an intractable problem, and many banks may be able to find ways to acquire the funds they need. In fact, with the record profitability in banking over the last five years, banks may have sufficient room to make adjustments and implement new funding strategies. Recent deposit trends, moreover, may be a sign of the changing financial environment, which is not only increasing competition among banks, other financial institutions, and the capital markets, but is also creating new funding instruments and bank delivery channels.

In examining funding problems at Tenth District banks, this article will first look at bank deposit trends and how they have affected community banks. Next, the article will examine several possible explanations for these trends and their implications for future funding patterns. The final section will explore the options banks have for dealing with funding shortfalls and how these choices might affect banks' operations and ability to serve customers.

FUNDING TRENDS AT TENTH DISTRICT BANKS

Deposits and other sources of funding make up a very simple, but important, piece of a bank's operations. As financial intermediaries, banks are in the business of attracting deposits from individuals, businesses, and other organizations and then lending such funds to customers with current credit needs. A bank's success in finding depositors consequently plays a critical role in its ability to satisfy customer credit demands and perform other banking functions. Moreover, much of a bank's profitability is derived from gathering deposits at one set of interest rates and then lending or investing these funds at higher rates. These key roles that deposits play in overall bank performance have thus drawn much attention to bank funding practices and the ability of individual banks to maintain or expand their deposit base.

According to recent trends, community banks in Tenth District states appear to be having more difficulty in attracting deposits than they did a dozen years ago.³ As shown by Chart 1, core deposits (total domestic bank deposits less domestic time deposits larger than \$100,000) have fallen quite dramatically at community banks—from more than 88 percent of all bank funding sources in 1988 to less than 81 percent in 2000. Virtually all of this decline came after the mid-1990s.⁴ This chart looks at core deposits because they are a commonly used measure of a bank's success in attracting funds through traditional banking channels. Such deposits are largely derived from a bank's regular customer base and, therefore, are typically the most stable and least costly source of funding for banks. Also, because of

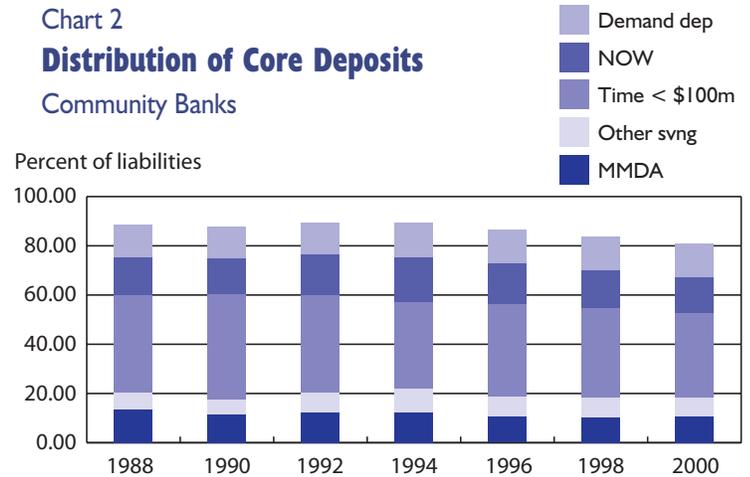
this customer relationship, core deposits are likely to be the funding source that is least sensitive to shifts in interest rates on competing instruments.⁵

Apart from the relative decline in core deposits, there are several other aspects of this trend that are important in understanding community bank funding concerns. These include which deposit categories are declining; what new sources of funding banks are using; how bank profitability has been affected by changes in funding sources and costs; and what differences might exist between rural and urban community banks.

The relative decline in core deposits at community banks appears to be part of a general trend affecting all core deposit categories: demand deposits, negotiable orders of withdrawal (NOW) accounts, time deposits under \$100,000, savings deposits, and money-market deposit accounts (MMDAs). As shown in Chart 2, each of these core deposit categories has shown some decline since the mid-1990s in relation to total liabilities at community banks. The decline in small time deposits has continued over an even longer period of time. As a result, community bank funding problems cannot be attributed to any single deposit category alone.

To fill the gaps left by declining core deposits, community banks in Tenth District states have made use of several alternative funding sources. Two of the most prominent have been time deposits over \$100,000 and Federal Home Loan Bank (FHLB) advances. From 1993 to 2000, large time deposits, or “jumbo” certificates of deposits (CDs), have grown from 7.3 percent of all community bank liabilities to almost 12.7 percent. During the same time frame, FHLB advances have grown from about 0.2 percent of all liabilities to nearly 3.5 percent.⁶ These two sources have thus made up almost all of the core deposit shortfall at community banks. Community banks have also used a number of other funding sources—most notably fed funds (short-term interbank credits), brokered deposits (deposits attracted through outside brokers), and seasonal borrowing from the Federal Reserve—but these sources have played a fairly small role at most institutions. Brokered deposits at community banks have grown from virtually nothing in the early

Chart 2
Distribution of Core Deposits
Community Banks

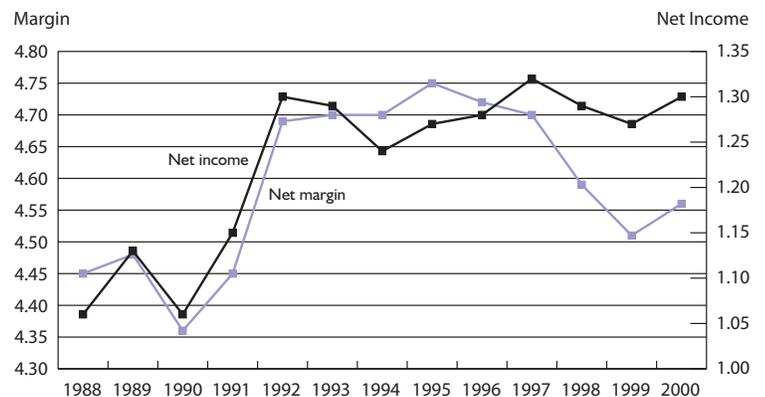


Source: Bank Reports of Condition and Income.

1990s to over 0.5 percent of all liabilities in 2000—a noteworthy increase, but still small compared to other funding changes.

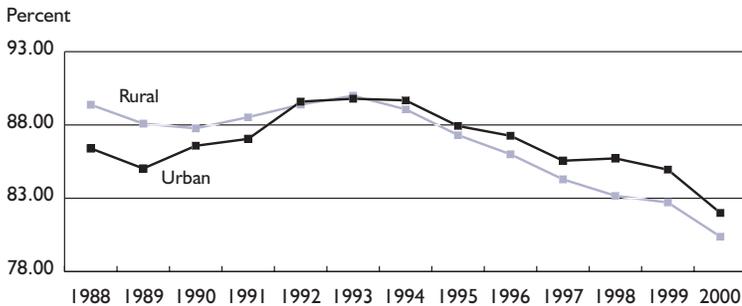
While banks have had to replace their “lost” core deposits with typically more expensive funds, Chart 3 shows that community bank profitability has yet to show any noticeable decline.⁷ In fact, average net income for community banks in Tenth District

Chart 3
Net Income & Net Interest Margin
(as a percent of average assets)
Community Banks



Source: Bank Reports of Condition and Income.

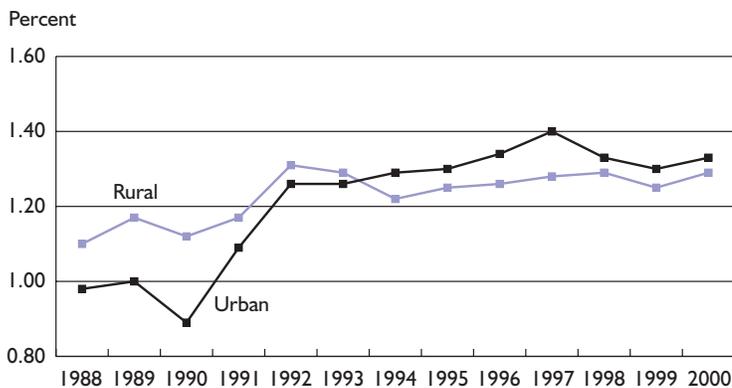
Chart 4
Core Funding to Total Liabilities
 Urban & Rural Community Banks



Source: Bank Reports of Condition and Income.

states has remained at or near record levels since 1992, reaching its highest point in 1997—1.32 percent of average assets. Chart 3, though, indicates a somewhat different trend in community bank net interest margins, which have been declining since 1995. This decline has not been large, but it does provide some evidence that funding costs are rising relative to the yields earned on bank assets and

Chart 5
Return on Average Assets
 Urban & Rural Community Banks



Source: Bank Reports of Condition and Income.

could eventually lead to declining earnings, provided other sources of income fail to grow or non-interest expenses or loan losses rise.

A final issue in community bank funding trends is whether there is much difference between rural and urban banks.⁸ Community banks in urban areas should have a broader pool of potential customers from which to solicit deposits, although they may also face competition from a wider range of financial institutions. Rural banks, on the other hand, are likely to have a more limited depositor base, and their customers may have fewer credit alternatives in the event of funding shortages. Since 1988, the general trend has been much the same for both groups of banks (Chart 4). However, rural banks have suffered a slightly greater loss in core deposits over the last few years.

Rural and urban community banks have also shown similar trends in income and net interest margins. Both groups of banks have had record or near record returns over much of the 1990s. Community banks in urban areas have achieved somewhat higher income levels since 1994, but the differences with rural banks have been quite small (See Chart 5). Also, urban banks have had higher net interest margins, but this may reflect the better opportunities they often have for making higher-rate consumer loans. Rural banks, moreover, appear to have made up much of the difference in margins through lower overhead costs and other steps. As a result, funding pressures and their effects do not appear to differ greatly between rural and urban community banks.⁹

POSSIBLE EXPLANATIONS FOR THE COMMUNITY BANK FUNDING TRENDS

So far, community bankers have generally been able to replace their “lost” core deposits with other funding sources and have managed to do so without significantly lowering bank profitability. Many bankers, though, are concerned that recent funding problems will continue and become even more intense, thereby forcing community banks to either make a major shift toward more costly and less sta-

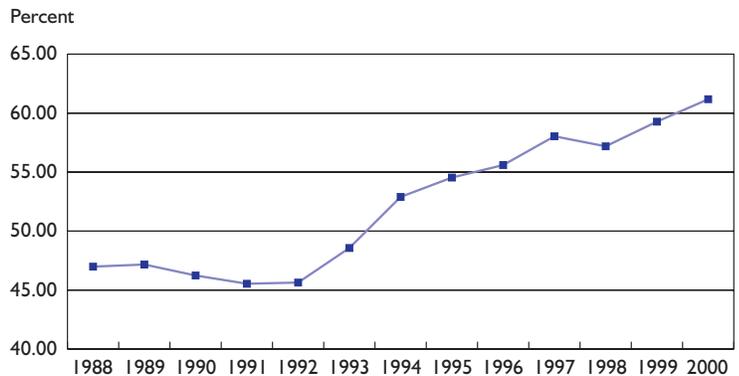
ble funding sources or curtail their lending to creditworthy customers. Whether these concerns are realized or not will largely depend on the factors behind the recent trends and the likelihood that such factors will play a continuing role. This section therefore examines possible explanations for community bank funding pressures, including strong loan demand, shifts in household portfolios away from bank deposits, new competition for community banks, the returns on different financial instruments, and changing demographics in many community banking markets.

Loan demand—Loan demand could have an important role to play in community bank funding pressures, since a substantial increase in loan business would prompt most bankers to look for new funds and make other balance sheet adjustments. Much of the evidence indicates that loan demand has increased substantially from the early 1990s to at least through 2000. Over this period, the economy has experienced the longest expansion phase in U.S. history, thus making consumers and businesses increasingly optimistic and willing to take on more debt.¹⁰

As an example of rising loan demand, the amount of consumer debt in the United States increased by about 80 percent from the beginning to the end of the 1990s. Mortgage lending and business borrowing have increased by comparable magnitudes. In addition, farm debt has shown a gradual, but steady, increase across Tenth District states over the last decade. A rising portion of this debt, moreover, is being captured by community banks, especially with other lenders cutting back on their operations in the aftermath of the 1980s agricultural crisis.¹¹ Overall, these trends suggest that many Tenth District community banks are now facing credit demands that are above historical averages.

The effects of strong loan demand, as well as the willingness of bankers to lend, can be seen in the amount of lending at community banks. Chart 6, for instance, shows that the average loan-to-asset ratio for community banks has risen from less than 46 percent in the early 1990s to more than 61 percent in 2000, which is at least a forty-year high. This substantial increase has caused bankers to cut back on their holdings of other assets. In addition, the

Chart 6
Loans to Assets
Community Banks



Source: Bank Reports of Condition and Income.

increased lending has undoubtedly placed a strain on community bank funding and required bankers to look beyond their traditional funding sources.

Changing household portfolios—Another trend contributing to community bank funding pressures is a significant shift in household financial portfolios away from bank deposits. Many individuals no longer hold a major portion of their financial assets in the form of bank deposits or deposits at other financial institutions. As a result, community banks may now be missing a substantial part of their traditional funding base. Table 1 illustrates the dramatic changes that have occurred in the composition of household financial portfolios.¹² Most notably, deposits in financial institutions have fallen from over 31 percent of all household financial assets in 1985 to less than 13 percent of the household portfolio in 2000.¹³ Over the same period, corporate equities have increased from under 15 percent of the portfolio to more than 25 percent, and shares in stock and bond mutual funds have jumped from under 3 percent to more than 11 percent of household financial holdings. These trends indicate that individuals have become accustomed to putting their money into a broad array of financial products, and, as a consequence, banks may not

Table I

Composition of U.S. Household Financial Assets 1985–2000

(percent share of total)

	1985	1990	1995	2000
Deposits	31.3	25.4	16.2	12.8
Money Market Mutual Funds	2.6	3.2	2.5	3.6
Debt Securities	11.6	13.7	11.0	7.8
Equity Securities	14.4	15.7	23.7	25.3
Mutual Fund Shares	2.7	4.0	6.6	11.1
Life Insurance, Pensions, Trusts	37.3	38.0	39.9	39.5

Source: Flow of Funds Accounts of the United States, Board of Governors of the Federal Reserve System.

be able to rely on households for funding to the same extent as in the past.

A variety of factors have been suggested as underlying reasons for this decline in household deposit holdings. For community banks, the most likely factors are new competition, higher returns on other financial assets, and changing demographics in community banking markets.

New competition for community banks—

Traditionally, community banks have competed mostly with other community banks for deposits and had little concern about competition from other sources. Over the last few decades, though, many new competitors have emerged and have been successful in offering alternatives to bank deposits. This new competition, in fact, has been a centerpiece in the revolutionary changes taking place within our financial system. Technological change in the form of improved communications and data processing has driven many of these changes by making it possible for a variety of institutions to develop new financial products and to reach out more effectively to bank customers.

One important example of the new competition for banks is money market mutual funds. These funds first achieved wide popularity in the late 1970s and early 1980s when deposit interest rate regulations prevented banks from offering competitive rates on time and savings deposits. After that, money market funds continued to grow as the public found them to be a safe and convenient way of holding short-term funds. From their start in the early 1970s, money market mutual funds have expanded to a point where they now greatly exceed total U.S. checkable deposits and currency combined, which clearly indicates the effect these funds have had on deposit competition.

Other growing forms of funding competition for community banks include credit unions, larger banks, securities firms, insurance companies, and several new entities. Credit union growth and expansion into many community banking markets have greatly intensified the competition for local customers. Also, securities firms and insurance companies have not only expanded their offerings for small investors, but, in some cases, have directly acquired banks and thrifts, most recently as financial holding companies under the Gramm-Leach-Bliley Act of 1999. Merrill Lynch has gathered over \$66 billion in deposits in the last few years through its two depository institutions. E*TRADE and Charles Schwab have recently acquired banks to expand their product lines, and State Farm and Allstate insurance companies are beginning to market banking products through their local agents and over the Internet. Other community bank competition is coming from Internet-only banks, electronic banking services offered by other banks, deposit brokers, and deposit listing services.

These new financial instruments and competitors thus provide a partial explanation for the shifts in household portfolios away from bank deposits. Furthermore, the direct entry by some of these firms into banking may help explain the greater competition community banks are now facing for deposits.

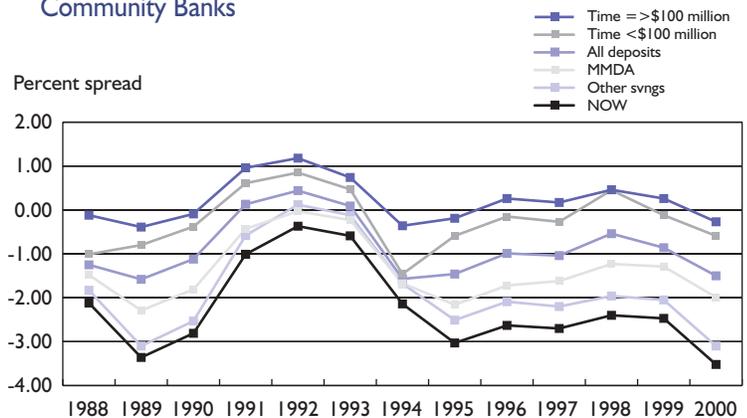
Returns on different financial instruments—Another factor that could play an important role in bank funding and the changes in

household financial assets is the rates banks pay for deposits relative to the returns available on other financial assets. During the 1990s, U.S. equity markets generated returns far above their historical averages, thereby drawing substantial volumes of new funds into equities. The average annual total return on stocks over the 1990s, based on the Standard & Poor's 500 index, was over 18 percent. In comparison, the average return on long-term, Aaa-rated corporate bonds was 7.7 percent during the 1990s, and the average yield on six-month Treasury bills was almost 5 percent.¹⁴ Lagging behind these returns was the 4.6 percent average rate paid on interest-bearing deposits at Tenth District community banks.¹⁵ Although such comparisons make no adjustments for differences in the risk or the maturity of each instrument, it is apparent that the stock market produced far more attractive returns than bank deposits. These differences in returns, moreover, explain much of the growing attraction of equity investments during the 1990s and the corresponding shifts that individuals made in their financial portfolios.

Comparing bank deposit rates to the yields on similar financial instruments provides a more detailed analysis of the rates community banks pay on deposits. Such a comparison helps to show the relative competitiveness of bank deposit rates, while also providing an adjustment for general movements in interest rates. Chart 7 shows the percentage point difference between the average deposit rates of community banks in Tenth District states and the rates on U.S. Treasury securities with similar maturities. A spread above zero in the chart indicates banks are paying a higher rate, while a negative spread indicates a higher return on comparable U.S. Treasuries.¹⁶

According to Chart 7, community banks have been fairly competitive in the rates they pay on large CDs (time deposits over \$100,000), but they have been less so on other deposits. In particular, the rates that community banks have paid on NOW accounts, MMDAs, and other savings accounts appear to have lagged noticeably behind U.S. Treasury yields since the mid-1990s, which also corresponds closely to the period of declining

Chart 7
Spreads to Comparable Treasuries
Community Banks



Sources: Bank Reports of Condition and Income and U.S. Department of the Treasury.

core deposits at community banks. The rates that banks have paid on smaller time deposits have been a little more competitive, but such rates have done little to stem the relative decline in this funding source. In fact, banks may be fighting an uphill battle in attracting smaller time deposits, especially given the strong incentives individuals have had to put longer-term funds into equity instruments.

These differences in yields thus suggest that other financial instruments have generally proven to be more attractive than bank deposits over much of the 1990s. Although community banks might have lost fewer core deposits if they had paid deposit rates more in line with U.S. Treasury yields, it is unlikely that such rates would have been able to stop much of the shift toward higher-yielding equity instruments.

Changing demographics in community banking markets—A final factor in the shift of deposit funds away from community banks might be the population trends within Tenth District states. Economists have hypothesized that stocks and mutual funds have become more popular in recent years due to an expanding middle-age population that is saving for retirement.¹⁷ According to this hypothesis, middle-age individuals — those between 35 and 65 years of age — have longer-term savings

goals and are more likely to prefer higher-return, less-liquid instruments, such as stocks, bonds, and mutual funds. In contrast, younger households typically have many new spending burdens, and their current need for funds is likely to dominate other financial objectives. As a result, younger households can be expected to hold more liquid financial assets, such as deposits and money market mutual funds. This preference for deposits and other short-term financial assets is also thought to be characteristic of older households with retired individuals, who are looking for liquidity and stability in their financial portfolios. These age group effects have generally been found to hold true in a number of different studies, including the Federal Reserve System's *Survey of Consumer Finances*.¹⁸

For Tenth District states, the percentage of the total population that is between the ages of 35 and 65 has increased from 33.5 percent in 1990 to over 38 percent in 2000. On the other hand, the proportion of the population between 20 and 34 years old has experienced a notable decline, and a slight decline has occurred in those that are 65 years or older. These population shifts would thus suggest that Tenth District banks now have proportionately fewer customers that are in the prime age groups for holding deposits.

Changing demographics may also be having other effects in Tenth District rural markets. Over 36 percent of the rural counties in Tenth District states lost population between 1990 and 2000, thus making it harder for community banks to generate deposits from their local population base. Another concern of community bankers is the aging population in many rural areas of the Tenth District. Over 14 percent of the population in rural counties was 65 years of age or more compared to just over 11 percent in urban areas. Moreover, a significant number of smaller rural counties had more than 20 percent of their population in this age category. This concentration of older customers led rural community bankers in our survey to offer these comments: "Elderly customers dying, their estate goes 10 different directions and there is no one there to take their place;" "Aging population in many of our small markets is a problem—As folks

die, money goes to kids in other locations;" and "Older people in rural areas—Deposits leave."

Which factors will continue to affect community bank funding?—All of the above factors appear to have made a notable contribution to funding pressures at community banks. Strong loan demand has increased bank funding needs. At the same time, changing household preferences for financial assets, new competition, high returns on other financial instruments, and changing demographics have all frustrated bankers in their efforts to maintain the existing base of depositors. Looking forward, these same factors are likely to play key roles in determining whether community bank funding problems become more intense or experience some easing over the next few years.

Several of these factors and ongoing trends suggest that funding pressures may lessen. For example, few people expect loan demand to continue to remain as strong as it has been, given the recent economic slowdown and the difficulty the economy may have in achieving a growth path like that of the last decade. Also, stock returns over the next decade are unlikely to be as high as in the 1990s. In fact, market downturns over the last year or so are encouraging people to take a closer look at other investment options, which could give bankers an opportunity to bring back some of their lost deposit business. Moreover, as the population ages and more people approach retirement, the liquidity, safety, and stable returns from bank deposits will become a stronger selling point.

Other factors, though, indicate that funding problems are likely to be persistent for community banks. Competition from other financial institutions will undoubtedly increase, as these firms become more adept at exploiting the Internet and other communications and business channels. Also, consumers and businesses will benefit from an ever-widening array of financial options, and banks will find fewer and fewer "captive" customers. Furthermore, the demographics of many rural markets aren't likely to improve much, with little or no population growth and the continued loss of major depositors.

Overall, these trends imply that community bank funding pressures are not likely to disappear, although some temporary easing could occur. Factors that suggest a potential easing in funding pressures—a possible drop-off in loan demand and lower stock returns—could help over the next few years, but will do little to offset such longer-term trends as rising competition for funds and expanding investment choices for bank customers.

OPTIONS FOR COMMUNITY BANKS

As financial markets continue to become more competitive, the challenge for community banks will be to look at a wider range of funding options and strategies and pick an approach that will allow them to grow and maintain a strong customer base. Depending on a bank's particular situation, an approach to funding problems could involve efforts to bring in more deposits, use new funding sources, or adjust the bank's asset holdings. The following options and strategies reflect these basic approaches and are among those most commonly suggested for community bank funding problems.

More competitive deposit rates—One obvious strategy for attracting more deposits is to pay more competitive rates. Chart 7 in the previous section indicated that Tenth District community banks had paid rates in several deposit categories that typically were below the yields on competing instruments. Banks may now have some room to offer more attractive deposit rates, given the record or near record profitability in banking over the last five years. Also, with recent downturns in the stock market, competitive deposit rates may have a somewhat better chance of bringing in deposits than they might have had a year or two ago. An American Bankers Association survey of community bankers indicated that many banks had already begun to counter their funding problems with more competitive rates. Nearly 68 percent of the banks in the 2001 ABA survey reported that their deposit pricing had become more aggressive over the last year compared to less than 24 percent of the banks in the 1999 survey.¹⁹

More competitive deposit rates may be essential for banks that wish to strengthen their relationship with local customers and prevent further erosion in core deposits. However, higher rates, by themselves, may not be enough to reverse all of the core deposit decline at community banks. Many bank customers, for example, have become accustomed to putting their money into mutual funds, stocks, and other investments, and some of this business may be hard to regain. Moreover, even if banks raise their deposit rates, a number of investors may continue to perceive equity markets as offering better long-term returns. Thus, while banks will certainly need to offer competitive rates in order to maintain deposits and keep from losing business to other institutions, other strategies may be needed as well.

Increased services for depositors—Another option for attracting more core deposits is to increase services for depositors. Personalized services and convenience have been a major part of community banking, and better services may be one of the best and most cost effective ways for community banks to fend off competitors and maintain a stable and loyal base of customers. Consequently, an important question for bankers to ask themselves is what can they do to make it easier for customers to open and use their deposit accounts. Several possible services that community banks might use to attract depositors include an additional ATM or branch in a convenient location, better cash management services for small businesses, improved account statements that aggregate all of an individual's business with a bank and its affiliates, and new insurance and investment services.

New deposit products—New deposit products provide one more way to attract depositors. As an example, online banking accounts with transaction services are being used by more and more community banks to strengthen their base of depositors and match the services provided by other institutions. Outside vendors of online banking products provide a ready means for smaller banks to begin offering more complex services over the Internet. For many community banks, such services are becoming more and more important, particularly as other firms, such as Merrill Lynch, Charles Schwab,

E*TRADE, State Farm, and many larger banking organizations, expand their own internet services and delivery channels in order to compete more actively for banking customers.

Banks have also begun to offer several new types of CDs. One example is the indexed CD, which allows depositors to have FDIC insurance and a guaranteed return of their original deposit, while receiving yields that are linked to a stock market index, such as the S & P 500.²⁰ These new deposit instruments offer a number of potential benefits to bank customers, but also carry a number of new conditions and terms that community bankers will have to carefully explain to potential depositors. In particular, indexed CDs typically have a number of restrictions that limit their returns to something less than actual stock market yields.²¹

Greater use of alternative funds—Apart from their traditional base of depositors, community banks have a number of other sources they can turn to for funding needs. One of these is FHLB advances. Community banks have greatly increased their use of FHLB funding over the past few years, and the 1999 legislative provisions, which expanded FHLB membership, borrowing purposes, and collateral requirements, are likely to lead to even greater borrowing.²² Other alternative funding options include Federal Reserve seasonal borrowings, fed funds purchases, large CDs, repurchase agreements, brokered deposits, and deposit listing services.

Many bankers expect these alternative funding sources to grow in importance. Over 63 percent of the bankers in our Tenth District bankers' survey reported that FHLB advances would make either a "rising" or a "much larger" contribution to their funding base over the next five years. Over 38 percent of the bankers planned on a greater use of large CDs, and nearly 29 percent believed fed funds purchases would occupy a rising share of their funding. While over half the bankers didn't anticipate much use of brokered deposits or Internet deposits, a notable portion of the other bankers expected to place growing reliance on these two options.

Community banks planning to make more extensive use of alternative funding sources will have to develop policies and strategies that address

the potentially greater volatility and higher cost of some of these instruments. In particular, a bank could lose access to such funding if its condition declines or if it is unable to continue paying competitive rates. Other factors that could impede this funding include market disruptions and, in the case of federally chartered funding sources, changing Congressional attitudes.

More selective lending—Another way for community banks to address funding problems is through better control of their assets, thus reducing the amount of funds needed. One such option is to lend on a more selective basis whenever funds are tight—either by raising credit standards or increasing loan rates and fees. Although this strategy could result in better credit quality and perhaps higher net interest margins as loan demand increases, it could also mean curtailing the amount of credit extended to creditworthy customers. Consequently, this strategy is not likely to be an answer to longer-term funding problems, since it would eventually impede a bank's growth and the development of its community.

Loan securitization and sales—The volume of funds a bank needs can also be controlled through loan securitizations, sales, or participations. Selling and participating out loans have long been used by community bankers to free up their balance sheets, better control risk exposures, and meet the needs of major borrowers. Bankers banks have further provided a means for coordinating such transactions. Loan securitizations offer another opportunity for banks to adjust their balance sheets, although much of this activity for community banks has been confined to conventional real estate loans.

Over 38 percent of the Tenth District bankers in our survey thought they would be making greater use of loan sales and participations to meet loan demand over the next five years. Fourteen percent anticipated that loan securitizations would become more important to them. These strategies are thus likely to play a greater role in community bank operations, particularly as secondary markets for bank assets continue to develop and evolve. To be successful, bankers will have to be careful that they do not sell off their best, most marketable, loans,

while allowing the quality of loans they retain on their own books to decline.

Changes in asset mix—Other possible ways of reducing funding needs include more efficient cash management, a smaller securities portfolio, and fewer fed funds sold. Community banks have already gone quite a ways in this direction, but our survey indicates many bankers plan to go even further over the next five years. Thirty-five percent of the bankers in the survey, for instance, anticipated that more efficient cash management and reductions in fed funds sold would make an even larger contribution in meeting loan demand. Over half the bankers expected reductions in securities holdings to become more important over the next five years. These strategies, though, will have to be properly planned out and administered if banks are to avoid reducing liquid reserves too far and increasing their balance sheet risks.

Legislative changes—Beyond bank funding options and strategies, another path that could help ease community bank funding problems is legislative changes in the form of greater deposit insurance coverage or authority to pay interest on demand deposits. Such changes have the potential to put community banks in a better position to attract and maintain deposits.

Many community bankers, for instance, have advocated raising deposit insurance coverage to \$200,000, indexing this coverage to inflation, and extending full insurance coverage to public funds. A recent American Bankers Association study by Mark Flannery estimated that increased deposit insurance coverage could expand domestic bank deposits by 4 to 13 percent, with four-percent growth representing the most likely outcome.²³ As a result, some of the core deposit decline experienced by community banks could be reversed by this proposed change. At the same time, though, Flannery's study indicates that banks would likely have to pay higher deposit insurance premiums under this proposal, due to the rising volume of insured deposits and a consequent decline in insurance fund reserves to below the statutory minimum ratio.

Community banks would also be in a better position to attract deposits if the interest prohibi-

tion on demand deposits, as legislated in the 1930s, were to be lifted. Several proposals have been introduced in Congress over the last few years to do this. Although banks would then be faced with the prospect of having to compete for such deposits on the basis of interest rates, they would undoubtedly be able to attract more demand deposits. In addition, bankers would no longer need to develop ways to give depositors implicit returns or to sweep demand deposits off the balance sheet overnight. Furthermore, most of the proposals have included provisions for the Federal Reserve to pay interest on the reserves that banks must maintain.

SUMMARY

The decline in core deposits at community banks in Tenth District states raises important questions about whether these banks will be able to remain successful and meet the credit needs in their communities. To some extent, recent funding problems have been accentuated by such factors as strong, cyclical loan demand and historically high returns on other financial assets, and banks could experience a temporary respite as these conditions change. However, other factors—most notably rising financial competition and an evolving financial system with many new investment options and more direct investor access to markets—point to continued funding pressures for community banks.

The most important step for community banks in addressing funding needs will be to develop strategies that are consistent with the needs of their communities and the significant changes taking place in banking. First and foremost, community banks will need to be aggressive in maintaining their local base of depositors and the resulting customer relationships. These customer relationships have defined community banking, and banks will need to offer a competitive range of products to keep their valued customers.

Ongoing financial trends, though, will require many community banks to look for other funding sources and to compete more directly for market-based funds. Most community banks have already begun taking some steps in this direction. With the

potentially greater cost and volatility of these new sources, community banks will have to be careful to diversify their funding, establish backup or emergency sources of liquidity, and develop the expertise to manage new funding strategies.

Overall, innovative and forward-looking community bankers will continue to have many opportunities and resources for meeting community credit needs and maintaining successful operations. Although changing financial markets may have made it harder for community banks to attract funds through traditional channels, these changes have also helped to create new funding sources and better ways to manage banking assets.

ENDNOTES

¹ For such comments, see Ben Jackson, “Deposit Growth ‘Crisis’ for Community Banks,” *American Banker*, February 26, 2001, pp. 1, 6; Rob Garver, “Liquidity Rivaling Credit Quality as Crisis du Jour,” *American Banker*, October 30, 2000, p. 9; Ron Feldman and David Fetting, “Declining deposits...Is it all bad news?” *Fedgazette*, Federal Reserve Bank of Minneapolis, July 1998; and Steve Cocheo, “Community Bank Competitiveness Survey: How Does Your Bank Stack Up?” *ABA Banking Journal*, February 2001, pp. S1–S22.

² For more information on this survey see Forest Myers and Richard J. Sullivan, “The 2001 Survey of Commercial Banks in the Tenth Federal Reserve District: Changes and Challenges,” in this issue of *Financial Industry Perspectives*.

³ These states include Colorado, Kansas, Missouri, Nebraska, New Mexico, Oklahoma, and Wyoming.

⁴ This article looks at bank funding from 1988 to 2000 because this period was after bank interest rate deregulation had been completed and thus no longer played a role in bank funding trends. In addition, some of the information used in this article from bank Reports of Condition and Income was not available on the same basis prior to 1988.

To provide a more consistent definition of community banks over time and to control for the growth in individual banks, this article classifies community banks on a relative scale. Banks in Tenth District states are defined as community banks for any year in which they are not within the top quartile of banks in the country by asset size. For 2000, this criteria produced an upper size limit for community banks of about \$171 million in total assets, with somewhat lower limits in earlier years.

In addition, this article only looks at established banks with CAMELS composite ratings of “1” or “2.” This restriction thus means that the general funding trends presented here should not be significantly influenced by funding difficulties at problem institutions or by changing bank conditions.

⁵ Larger banks in Tenth District states have also experienced similar declines in core funding over the past few years. However, this decline at larger banks may not be of as much concern, since these banks typically have better access to financial markets and to a wider range of funding options. In addition, many of their customers may have other sources to turn to for credit needs. Thus, while this article may have some implications for larger banks, its primary focus will be on community bank funding issues.

⁶ Banks first became eligible for FHLB membership in 1989, provided they had at least 10 percent of their assets in residential mortgage loans. These membership standards were further broadened in 1999 to include any bank with less than \$500 million in total assets (“a community financial institution”). Banks may borrow for housing finance purposes and must secure these advances with residential first mortgages or related securities; other low-risk, real estate-related collateral; U.S. Government or agency securities; or FHLB deposits. In addition, community financial institu-

tions can borrow funds to lend to small businesses, small farms, and small agri-businesses and may secure the advances with secured loans for small business and agricultural purposes or related securities.

- ⁷ For a comparison of core funding costs with that of other funding instruments, see Allen Puwalski and Brian Kenner, "Shifting Funding Trends Pose Challenges for Community Banks," *Kansas City Regional Outlook*, Federal Deposit Insurance Corporation, Third Quarter 1999, p. 15.
- ⁸ For this article, urban banks include any community bank located in a metropolitan area as defined by the U.S. Office of Management and Budget. Conversely, rural banks would be community banks that are located outside of such areas.
- ⁹ For a more detailed comparison of rural and urban bank funding pressures, see William R. Keeton, "Are Rural Banks Facing Increased Funding Pressures? Evidence from Tenth District States," *Economic Review*, Federal Reserve Bank of Kansas City, Second Quarter 1998, pp. 43–67. This article found that small rural and urban banks have generally faced similar funding pressures.
- ¹⁰ National Bureau of Economic Research, "U.S. Business Cycle Expansions and Contractions," 2001.
- ¹¹ Farm debt-to-equity ratios for the 1990s, though, have remained notably below those of the 1980s, due to more conservative attitudes on the part of farmers and bankers and a gradual increase in land values over the last decade.

Additional evidence on rising agricultural loan demand can be seen in the Federal Reserve Bank of Kansas City's *Survey of Agricultural Credit Conditions*. In this survey, agricultural bankers in the Tenth District have reported rising loan demand throughout the 1990s. More recently, these bankers have also indicated that more loans are remaining on their books due to low crop prices and the resulting declines in loan repayment rates and increases in loan renewals and extensions.

- ¹² For other studies on household financial assets, see Donald P. Morgan, "Will the Shift to Stocks and Bonds by Households Be Destabilizing," *Economic Review*, Federal Reserve Bank of Kansas City, Second Quarter 1994, pp. 31–44; and Elizabeth Laderman, "Deposits and Demographics," *Economic Letter*, Federal Reserve Bank of San Francisco, June 27, 1997.
- ¹³ These statistics come from the Federal Reserve Board of Governors' Flow of Funds Accounts, Table B.100—Balance Sheet of Households and Nonprofit Organizations, 1985–2000. Although these figures include nonprofit organizations, such organizations make up a very small proportion of the total figures. To limit the analysis in this paper to standard financial instruments, the numbers presented here exclude several items listed as household financial assets in the Flow of Funds statistics. These excluded items are security credit, non-corporate equity, and miscellaneous assets.
- ¹⁴ The sources for these returns were the *Statistical Abstract of the United States: 2000*, U.S. Census Bureau, Table No. 826, p. 523; and Table A23 (Interest Rates: Money and

Capital Markets) in various *Federal Reserve Bulletins*.

- ¹⁵ The returns on bank deposits presented in this section are based on information community banks provide in their quarterly Reports of Condition and Income. More specifically, these returns are calculated by dividing the deposit interest expenses banks report for an entire year by their average annual, interest-bearing deposits (as derived from the reported quarterly average deposit figures). Since banks report these numbers for each deposit category—NOW accounts, MMDAs, small time deposits, etc.—a deposit interest rate can also be calculated for each category.
- ¹⁶ In Chart 7, the rates on NOW accounts, MMDAs, and other savings accounts are compared to an average of the rates on three- and six-month Treasury bills, based on the premise that any deposits in these categories can be withdrawn on demand or within short notice. Time deposits over \$100,000 are typically 90-day instruments and are therefore compared to three-month Treasuries. Banks often offer a wide variety of maturities on smaller time deposits, including some longer maturities. As a result, the rates on smaller time deposits are compared to the average of one- and two-year Treasury security yields, although possible shifts in the maturities of small time deposits over this period could complicate the analysis.
- ¹⁷ Morgan, "Will the Shift to Stocks and Bonds by Households Be Destabilizing;" Laderman, "Deposits and Demographics;" and Feldman and Fettig, "Declining deposits...Is it all bad news?"
- ¹⁸ For more information about this survey, see "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 86 (January 2000), pp. 1–29.
- ¹⁹ Cocheo, "Community Bank Competitiveness Survey: How Does Your Bank Stack Up?" p. S11.
- ²⁰ Initially, indexed CDs were only offered by large banks that could arrange the necessary interest rate swaps and hedging transactions. More recently, though, community banks have been able to offer indexed CDs through partnerships with larger organizations.
- ²¹ These restrictions, for instance, might include: (1) yield caps that set a limit on the highest rate payable on the CD, (2) a percentage limitation on how much of the actual increase in the stock index can be paid to depositors, or (3) an averaging formula which takes an average of where a stock index stands at various times during the term of the CD rather than giving depositors the full gain in the index.
- ²² For a detailed analysis of the use of FHLB advances by banks, see Dusan Stojanovic, Mark D. Vaughan, and Timothy J. Yeager, "Do Federal Home Loan Bank Membership and Advances Lead to Bank Risk-Taking?" (Federal Reserve Bank of St. Louis), a paper presented at the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 2001.
- ²³ Mark J. Flannery, "Increasing Deposit Insurance Coverage:

Implications for the Federal Insurance Funds and for Bank Deposit Balances,” prepared for the American Bankers Association, December 2000.

Flannery’s estimates of deposit growth were based on telephone surveys of small businesses and affluent individuals.