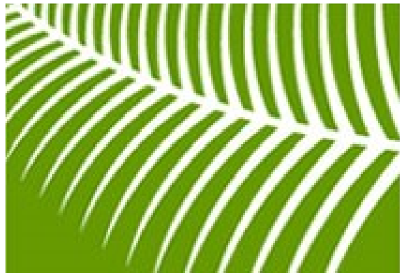

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3

The Role for Correspondent Banking: A Money Center Perspective

John W. Ballantine

The banking industry, or perhaps more precisely the financial services industry, is in the process of being radically reshaped. This is occurring not only as a result of increasing competition from the entire spectrum of domsetic and foreign financial and non-financial institutions, but also as a result of generic changes in the bank services market.

Prospectively, changes to those laws which govern the geographic and operating franchises under which each bank operates will have much to do with the timing and extensiveness of this restructuring. More significant, however, is the potential for change resulting from a deregulation of financial institutions. The ultimate shape of the financial institutions market is not yet ascertainable, although certain trends are obvious. We can be certain that the correspondent banking system will be significantly altered as historical regulatory and competitive constraints are removed.

In order to logically explore the possible effects of such changes and how they might affect the relationships which now exist among money center banks and their agricultural correspondents, it is first necessary to examine and understand the basic elements of the existing system. This descriptive process should focus on three sets of interrelated issues: definitional issues, structural issues, and risk vs. return issues. Once we have briefly explored these issues we can, by thinking of them in the context of possible future environments, reach some conclusions as to the directions that correspondent relationships will take.

Definitional Issues

For the most part, we have a relatively uniform idea as to what an

agricultural bank is in the context of correspondent banking. There is, however, less than universal agreement as to which banks are money center institutions.

The general definition of such an institution typically centers on three major characteristics: size, location, and funding capability. Other, secondary characteristics, such as range and sophistication of services or diversification of interests, can be included in defining the scope of this market, but are almost always observable only where the major characteristics are present.

Based on this premise we might conclude that there are some 20 to 25 domestic banking institutions that are money center banks. However, in terms of correspondent relationships, that list should be expanded to include other financial institutions (e.g., insurance companies, trust companies, investment bankers) as well as nonfinancials to the extent that such companies would choose to forge mutually beneficial relationships with agricultural banks. Additionally, there are many foreign banks operating domestically which meet our criteria as money center institutions, and they too should be included in any discussion of potential participants in this market. To the extent that smaller banks work to cultivate these institutions, market access to funding sources is greater than ordinarily assumed.

Structural Issues

Historically, funding relationships among money center and agricultural banks have been based on three principal factors. First, regulatory and legal constraints on banks resulted in a real need to create sustainable partnerships in order to satisfy local credit needs. Second, the same constraints which limit smaller banks in terms of their capability to book assets have contributed to relative higher asset liquidity in those banks. And, third, larger banks have generally had relatively high liquidity on the liability side, a capacity to attract funding that has generally exceeded their capacity to generate reasonably priced assets. In essence, we have had a system of recycling which successfully satisfied market needs and artificial constraints.

If, for example, a bank has a request for financing from a customer which is in excess of its legal lending limit, it typically has sought to sell the overline to a correspondent, thereby achieving its objectives of servicing its local market without violating a specific legal constraint. Likewise, it might be necessary for a bank to sell participa-

tions as a result of other artificial constraints, whether those constraints were created internally (e.g., policies relative to portfolio diversification) or externally (e.g., regulator mandates or concerns as to overall leverage or risk asset ratios), or real constraints (e.g., lack of funding capacity or liquidity).

The purchasing bank has not only obtained an earning asset through this process, but has also strengthened its relationship with the selling bank. This is an extremely important point because, in terms of aggregated numbers, smaller banks have been net providers of funds to money centers. Perhaps most important is the fact that the funding provided by smaller banks—not only demand deposits, but large denomination CD's, Fed funds, and the like—has been relatively low cost and extremely stable relative to other funds sources.

To put it even more simply, smaller banks have historically utilized their correspondents in order to satisfy critical needs on the demand side, and they have simultaneously satisfied the net supply side needs of their correspondents on a cost-effective basis. The symbiotic nature of this recycling process is one of the fundamental elements of an efficient and effective correspondent banking system.

Risk vs. Reward Issues

In the process of transferring assets to its money center correspondent, the local bank has also transferred some portion or all of the risk inherent in that asset. While the basic process of recycling allows satisfaction of market needs for participants in terms of funds flows, it neither distributes risk evenly nor does it assure adequate compensation for risks incurred in the process. Furthermore, costs, both funding and administrative, differ widely among participants in the recycling process and, consequently, net returns may be more than adequate to one participant and less than adequate to another even if gross compensation is well distributed. A short series of hypothetical examples may be helpful in illustrating the problems related to this issue.

Tradition Overline

In this example, we assume that the smaller bank must sell an overline to its money center correspondent and that the selling bank is simultaneously providing some funding to the purchasing bank in the form of demand deposits, Fed funds, or some combination of the two.

The seller has, of course, been able to meet its customer's request but, in order to do so, has generated a mix of earning assets (the loan, Fed funds sold) and non-earning assets (due from balances) which probably have a lower gross return than would have been achieved had the entire loan been booked. The selling bank's risk is presumably lower and so is its potential return although this is balanced, at least in part, by the fact that external constraints forced the sale of the overline.

The purchaser, however, has now assumed whatever risk is inherent in the transferred asset. To the extent that the purchaser could have created an asset with a greater relative net yield (based on gross yield as well as funding and administrative costs) he has lost profit opportunity, unless the relationship between the seller and the purchaser is such that a lower cost structure is afforded the purchaser in order to assure an appropriate net return. To the extent that the seller subsidizes the purchaser (e.g., through a mitigation of funding costs) in order to provide an adequate net, the seller's return may be inadequate. If the seller is unwilling or unable to subsidize the purchaser for risk assumed, the purchaser may be unwilling to enter into the transaction.

Sale of Assets for Liquidity Purposes

In this example we assume that the smaller bank wishes to sell a loan or a group of loans either because its funding sources have been exhausted or because it has reached or exceeded a desired or mandated degree of leverage.

The prospective purchaser in this example is probably not being funded in any significant way by the seller. Consequently, there is little or no subsidy available to the purchaser, and the asset must have a gross yield such that the purchaser is satisfied that his net return, based most likely on pricing relative to his marginal cost of funds, is adequate relative to his assumption of risk and administrative burden.

Direct Funding of a Smaller Bank

In this example we assume that the smaller bank has the capability and desire to assume all local risk and has sought direct funding, in the form of either short- or long-term debt, from its upstream correspondent. In this case the larger bank is presumably willing to adjust its pricing and prospective return in consideration of the mitigating effect of diversification of risk created through intermediation and,

possibly, some subsidy created out of the existing correspondent relationship.

The smaller bank, in choosing to accept individual local risks funded by the direct support from its correspondent, or by a combination of that direct funding and a resultant increase in leverage capability, now bears the risk that its gross and net returns (accounting for a marginal cost of funds) will be sufficient to justify its complete assumption of risks.

There are some common concepts that can be gleaned from these examples. (1) If pricing to the borrower is inadequate to compensate for risk and the costs of doing business, some subsidy will have to be introduced to create an incentive for recycling. (2) Subsidies are almost always provided by the smaller, or selling, bank either in the form of cost subsidies or by disproportionate risk absorption. (3) Larger, purchasing entities generally have greater control over the nature of sale-purchase transactions.

It is apparent that the recycling process has successfully met the need to redistribute assets and to compensate the participants for risk redistribution through a combination of direct pricing and subsidy of costs. Smaller banks have historically used their relatively lower cost local funding to provide the necessary subsidies; their local economies, as a result, have been well served as community credit needs were met through this process.

Summary of Issues

Prior to an exploration of future directions, it is appropriate to first summarize the issues raised in our examination of the existing process by which local credit needs are met utilizing the partnerships between agricultural banks and their money center correspondents.

First, we should expand our view of potential partners from just money center banks to money center institutions: the entire range of large institutions with money center funding capabilities should be looked at as potential correspondent partners.

Second, the current recycling process exists principally as a result of structural constraints. Liberalization of constraints would lessen the need to recycle. Continuation or proliferation of certain constraints would make recycling unachievable.

Third, risk redistribution requires a redistribution of potential net return. It has depended, in the past at least, either on the realization of

attractive market yields or subsidies of costs, whether those costs were administrative or funding. Extremely low pricing or extremely high costs can make redistribution impossible.

Salient Future Trends

There are at least two trends that are of significance in regard to correspondent relationships and how those relationships may be altered in the future.

The most important trend, or set of trends, has to do with the increasing emphasis which has to be placed on asset and liability management techniques. While money center banks have employed a variety of techniques for a number of years, with varying success, deregulation is forcing smaller banks, principally through a series of actions which have increased the cost and volatility of cost of funds, to adopt similar methods. However, smaller banks do not enjoy the same flexibility as their money center counterparts; their ability to select from alternative sources of funds or to generate alternative earning assets is, for example, much more limited. Consequently, they will have an extremely small tolerance for error as deregulation continues.

The very nature of agricultural credit markets exacerbates this problem. The proliferation of governmental lending vehicles, for example, has been a significant factor in terms of the relatively thin pricing which characterizes agricultural credit markets. While national social and economic goals may be furthered through governmental subsidies of borrowing costs, pricing of agricultural credits in highly competitive capital markets may not be sufficient to cover recycling costs in the future.

Conclusions

Traditional approaches will undoubtedly survive for at least the next five to ten years although pricing, especially on smaller credits, will have to be adjusted upwards in order to cover higher funding and administrative costs.

Much of the credit generated by smaller agricultural banks, however, will be cycled into regional banks rather than money center banks. While this has always been true to a degree, the rapid growth of regional banks has resulted in an increasing capacity to attract

funds and a resultant appetite for assets which can be efficiently generated through their regional correspondent networks.

Major money centers will continue to support their agricultural correspondents in the historical manner, especially if they have a definite commitment to helping agricultural banks or a desire to leverage existing resources dedicated to the agricultural market. Moreover, money center institutions are increasingly likely to attempt to service this market through corporate finance and investment banking techniques which result in fee income without any significant assumption of risk. Packaging of agricultural loans for resale is a valid concept; the questions of market acceptance, depth, and mechanics remain to be answered.

Finally, cross-streaming of local credits will undoubtedly increase during the next decade as banks within a particular locality choose to work more closely in order to protect their markets and preserve their profitability through more efficient administrative handling of smaller credits.

In conclusion, the traditional correspondent relationships among agricultural and money center banks are going to be restructured substantially. The principal catalyst of change is the ongoing deregulation of financial institutions. To the extent that this deregulation results in significant cost increases to agricultural banks, they will be unable to subsidize the traditional recycling process without impairing their own profitability.

Consequently, agricultural banks must seek to enforce market pricing levels which are sufficient to assure adequate returns, whether those assets are held on or off their balance sheets. Pricing must be attractive relative to alternative earning assets in national markets to assure the availability of funds, and administrative complexity must be minimized to assure efficient recycling.