

## Marginal Cost of Funds

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Today's Fed Funds futures shows investors are expecting a 93% probability of a 25 basis point hike at the December meeting. Whether or not this timing is correct, it is prudent to prepare for rising short-term interest rates in the not too distant future.

After years of speculating about the timing of an increase in deposit costs, it appears close to becoming a reality. The Bank's relationship managers speak regularly with members throughout New England, and they report that while there are certain areas where deposit growth has slowed somewhat, loan growth remains solid. If this is the case for your institution, it is especially important to have a plan in order to fund the loan growth necessary to meet profitability targets while maintaining your net interest margin. This rising rate environment could be considerably more challenging to members than in the past. Deposit composition has shifted in the past seven years from an almost even split of non-maturity and time deposits to one where non-maturity deposits comprise almost two-thirds of total deposits. Given the extended period of this low rate environment, these depositors may be quick to jump at higher yields, resulting in a level of price sensitivity unlike anything we have seen. This is understandable given the shift out of time deposits that occurred over the past seven years.

With all these forces aligned to increase your cost of funds, it is imperative that members be aware of the marginal cost of funds as they compete for deposits to fund the growth on their balance sheets. Let's examine the case of an institution that has \$40 million in an MMDA service line and is currently paying 50 basis points, or \$200 thousand in annual interest expense. Management is considering a 25 basis point increase in the rate to fund loan growth. They expect to see growth of five percent or \$2 million. If they raise the rate to 75 basis points and the balance grows by five percent, they will be paying 75 basis points on \$42 million in balances, or \$315 thousand in annual interest expense.

We can calculate the marginal cost of funds on this strategy as follows:

- The increase in annual interest expense is \$115 thousand (\$315 thousand less \$200 thousand).
- The change in balances for the two strategies is \$2 million (\$42 million less \$40 million).
- The change in interest expense divided by the change in balances produces a marginal cost of funds of 5.75 percent ( $\$115,000 \div \$2,000,000 = 5.75\%$ ).

But how can the marginal cost be higher than the rate paid on the account of 75 basis points? Let's look at it this way. You paid an additional 25 basis points on \$40 million of existing balances which will cost \$100 thousand per year and you're paying 75 basis points on \$2 million of new money or \$15 thousand per year. In this case, your cheapest source of new funds is FHLB Boston. Even though advance rates have jumped in recent weeks, you could still borrow a three-year Classic advance at 1.83 percent. This would result in total interest expense of \$236,600 or \$78,400 less than the \$315,000 it will cost to try to grow the Money Market product line. Now that interest rates appear to be headed higher, you must consider the marginal cost of funds when making all your funding decisions. You must "analyze before you act" . . . your net interest margin will thank you!