Deposit Strategy: Preparing for Rising Rates

BY RICHARD SOLOMON, ADAM STOCKTON AND SHERIEF MELEIS

While the exact timing of the next upward rate cycle remains unclear, banks are definitely running out of time to prepare. What will determine future winners?

The banking industry has anxiously awaited a rising rate environment, anticipating that interest income from loans and investments will rise more quickly than interest expense on deposits and other funding. Sure that deposit rates will lag industry-wide, many banks believe they can win by simply coasting with market trends.

But a lot has changed in the industry since the last upward rate cycle, in particular the increased relevance of direct banks, and the next cycle may present a more complex and challenging setting for deposit pricing. And while Novantas research confirms a strong industry trend of lagging deposit rates in prior cycles, institutional performance was widely dispersed, with some banks faring far better than others.

As the Fed Funds rate rose by 422 basis points from the summer of 2004 to the fall of 2006, the most aggressively priced banks saw their cost of deposits increase by 329 basis points. By contrast, top performing banks saw an increase of only 140 basis points, capturing a funding advantage of 45 basis points per every 100 basis-point increase in the Fed Funds rate (Figure 1).

This is a huge difference when extended across multi-billion dollar deposit portfolios, and less-prepared banks could be further handicapped in the next rate cycle. The customary shift to higher-yielding certificates of deposit may be much more pronounced, leaving far less time for coping strategies than what many bankers perceive.

While the exact timing of the next upward rate cycle remains unclear, some rate benchmarks (e.g., one or more years) have already started rising, and banks are definitely running out of time to prepare. Skills, strategies and operational routines for deposit pricing need to be refined and tested now. There are three imperatives:

First, more precision will be critical, both in market and customer analytics. Some regional banks still need work on the fundamentals of elasticity-based pricing, including localized strategy for each pricing market. And the next frontier of specialized deposit pricing will extend analytics to a segment and customer level. These capabilities will be essential in allowing banks to lag rates broadly while precisely targeting price-sensitive shoppers.

Second, scenario plans and strategies need to be mapped out in advance. The advent of a true market jump is not the time to convene executive teams. Alert banks are working now to develop flexible pricing responses to various market scenarios. This is particularly important given that CD rates are actually tied to longer-term benchmarks, such as 1-year and 5-year Treasury rates, which have already started rising.

Third, the operational mechanics of segment- and customer-level deposit pricing need to be put in place, including analytics, technology build, testing and rollout. To succeed, advanced capabilities must be fully in use for the entire rising rate cycle.

On the strength of this preparation, winning banks will be much better positioned to preserve low-cost core deposit funding in the next season of rising rates.

ON THE VERGE?
While the rate environment has seemed endlessly flat, history shows that changing conditions can materialize fairly quickly. Importantly, most market indexes move well in advance of deposit pricing trends.
of any formal actions announced by the Federal Reserve, and once things get started this time around, Internet-based deposit competition could be a game-changer.

One of the key questions that bankers are asking right now is what to look for — what are the signs that a rising rate environment really is coming? While most institutions see the Fed Funds rate as the barometer, this only tells part of the story, mostly affecting short-term savings and money market deposit accounts.

Also impactful are benchmarks for longer-term rates, which have a significant bearing on certificates of deposit. In the prior two rising rate environments, for example, both the 1-year LIBOR and 5-year Interest Rate Swaps moved in advance of Fed Funds increases, by eight to 12 months. Five-year CD rates rose in conjunction.

In the current environment, long-term interest rate swaps have already begun to rise from last year’s historic lows. In some markets, long-term CD rates have already followed, showing the beginnings of a typical rising rate pattern. While short-term rates will likely not begin to rise until after the Fed starts to taper quantitative easing, this event is now on the horizon and may occur early in 2014.

**Figure 1: Differences in Market Sensitivity**

In the last rate cycle, the cost of domestic deposits varied sharply among the top 50 U.S banking companies. Will the gap widen further next time?

<table>
<thead>
<tr>
<th>Period</th>
<th>Cost of Deposits¹</th>
<th>COD Change</th>
<th>Change per 100 bp Fed Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highest</td>
<td>+329 bp</td>
<td>+78 bp</td>
<td></td>
</tr>
<tr>
<td>3rd Quartile</td>
<td>+237 bp</td>
<td>+56 bp</td>
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<tr>
<td>2nd Quartile</td>
<td>+201 bp</td>
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<tr>
<td>Lowest</td>
<td>+140 bp</td>
<td>+33 bp</td>
<td></td>
</tr>
<tr>
<td>Hi-Lo Diff</td>
<td>189 bp</td>
<td>45 bp</td>
<td></td>
</tr>
</tbody>
</table>

¹ Interest expense on domestic deposits as a percent of average balances.

Source: Analysis of data from Highline Financial by Novantas, Inc.
will come as customers who left CDs over the past five years begin to perceive a meaningful difference in CD yields, enough to start shopping and consider switching back to these accounts.

**MARKET RESPONSIVENESS**

The $64,000 question in a rising rate environment is the degree of impact on deposit rates. In the last two upward cycles, rates on interest-bearing deposits reflected 53% of the increase in Fed Funds, in both the 1999–2000 and 2004–2006 cycles.

But the averages can be misleading. Based on a Novantas analysis of Informa data, promotional MMDA rates rose by 52%–71% of Fed Funds, while promotional CD rates reflected 70% to 89% of duration-matched benchmarks. Given that these spikes far exceeded the overall cost of deposits, it is obvious that banks were able to maintain substantial books of deposits priced well below promotional offers.

In addition, the magnitude of market movement varied dramatically by region. Our analysis of San Francisco, Miami, Cleveland, and Philadelphia showed up to a 20% difference in market movements within a given product category (Figure 2).

Such differentials will likely resurface in the next rate cycle, with important implications for bank preparation. The next rate environment may be quite different for several reasons, and there are positive and negative factors that will impact banks’ ability to capture any net interest margin improvement.

Among the negative factors:

- Compared with 2006, the Internet has become a much more powerful force in banking. This includes competition from direct banks, the advent of digital shopping for banking products, and the dwindling potential for customer engagement within the branch. While direct banks still have about a 5% market share of deposits, Novantas research suggests as many as 60% of customers shop online before they buy. Even for those customers who ultimately choose a traditional bank, direct banks are an increasingly important component of the reference rate, and their growing influence on consumers will spur greater rate competition.

- The erosion of branch traffic will make it more difficult to stem impending defection among established accounts. In prior rising rate cycles, a typical strategy to save high-value customers and large balances included “back pocket” or “desk drawer” offers, extended by branch and contact center reps empowered to offer a promotional rate to customers who threaten attrition. This technique will be less available to banks as more customers “silently attrite” without a conversation with a bank rep.

- Pent-up rate hunger among depositors may unleash more of a shopping surge than what might have been seen before. Customers have struggled through a long era of depressed rates and have had little motivation to look around. But their appetites could easily be rekindled in a shopping event prompted by rising rates, accompanied by market excitement and heavy advertising from institutions needing to grow their deposit books.

- Regulation (and experiences through the liquidity crisis) places higher value on core deposits,
suggesting banks may compete more aggressively for retail deposits. Among the positive factors:

- Retail banking returns are now sub-hurdle (down from 30+% pre-crisis), and banks are looking for means to replace lost revenue, collectively incenting institutions to lag more aggressively.
- Novantas analysis suggests the biggest driver of deposit price competition is loan growth, and if the tepid recovery in credit continues, most banks will have less motivation to aggressively compete. However, those institutions with growing loan portfolios may be far more aggressive than the average bank.
- Typically in a rising rate environment, money flows out of deposits into money market mutual funds, but recent regulatory changes and the “breaking of the buck” have rendered money market mutual funds less attractive.

In combination, all of these factors will likely lead to a barbell effect as aggressive high-rate competitors clash with overall industry efforts to lag. This will make this environment more challenging to navigate than ever before.

**Market Imperatives**

In this environment, pricing skills will be critical, including precision, planning and execution. Banks caught flat-footed could find themselves paying extra to replace balances that otherwise might have been retained at lower cost.

**Precision.** Banks will need to be able to gather rate-sensitive funds without repricing the entire book of business and giving up substantial margin. Regional pricing strategies (which were less important in the low-rate environment) will be increasingly important again, as different markets exhibit substantially different competitive conditions, and banks will need the flexibility to react on a market-by-market basis.

However, we believe that regional pricing skills will provide only part of the answer in the upcoming cycle. Technology and analytics have evolved to enable segment and even customer-targeted pricing as well. Banks will need to identify and target those customers who are most likely to respond to rate offers, and continue a pricing paradigm after account acquisition to make informed tradeoffs between balance formation and margin enhancement.

These customer-level techniques, similar to those practiced in the credit card industry for decades, had been viewed as inapplicable in traditional branch banking, which has struggled to deploy finely differentiated offers at the point of sale. But they are increasingly feasible in a “direct-to-consumer” world where more sales and account renewals are conducted electronically via online and mobile channels.

**Planning.** Banks can no longer rely on the periodic deliberations of executive committees to set deposit pricing. Given the rising need for quick responsiveness to a more electronically-driven market, the bank needs a set of flexible plans that are responsive to varied scenarios, considering funding needs and market conditions.

On the strength of this preparation, rate offers can change on a daily basis if needed, yet remain within the bank’s overall pricing framework. This allows for maximum responsiveness without placing undue burdens on executive time.

**Execution.** Banks will need to develop and test field capabilities before the rate environment rises in earnest. The analytic insights developed at headquarters need to be translated into a set of specific actions to be taken across the various regions, distribution channels and customer groups.

During the recent lull, some institutions have delayed investing in important capabilities, for example, customer level pricing analytics and delivery capabilities. They may be caught off-guard when the market moves, given that it takes time to fully implement these capabilities, including technology build, testing and rollout. Other banks have the capabilities but have not used them in a number of years, leaving institutions unsure of their potential effectiveness and the magnitude of customer reaction. While a Fed Funds increase may be delayed, long-term rates often begin to rise well in advance. Coping difficulties in the prior rising rate cycle contributed to a dramatic performance gap, and the skews could be even wider next time around, given the new complexities of online competition and engaging the multi-channel customer. Winners will prevail on the strength of preparations underway now.

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