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PERSPECTIVE

Rising Rates and Deposit Pricing: Pacing and Planning Will Pay

BY ANDREW FRISBIE AND ADAM STOCKTON

At Long Last! The Federal Reserve has just raised its benchmark Fed Funds rate by 25 bp — after seven long years at rock bottom. Overall, banks are breathing a huge sigh of relief, with the expectation of higher loan yields and revenue. But deposit gathering bankers must now face the reality of how to set deposit rates in response to rising interest rates — and in light of significant changes in regulation, competition and customer behavior patterns. Novantas briefly points out here some of our views on how this rising rate environment will compare to prior ones, and on the value of nimble planning and smart analytics.

WHAT HAPPENS NEXT?

- Modest deposit betas for initial rate increases
- More variation among banks
- Increased customer churn
- Eventual higher betas for subsequent increases

WHAT SHOULD DEPOSIT BANKERS DO?

- Get the core analytic foundation in order
- Set contingency strategies – prepare now or pay later

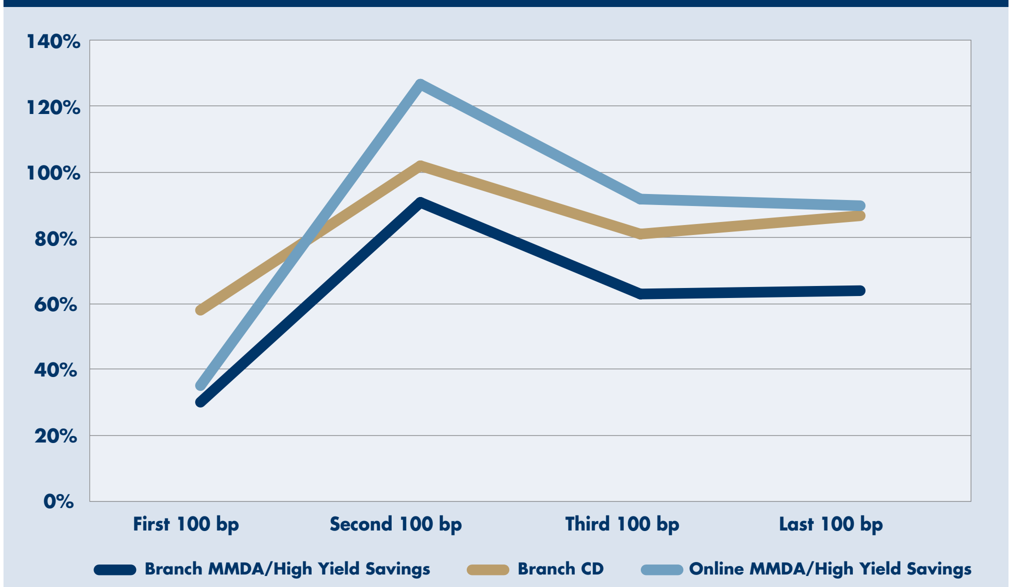
What Is Likely to Happen Next? Without going into a full analysis of how deposit rates will play out, several expectations seem to us clear under a more likely "base case" scenario. First, most banks will lag the initial Fed Funds rate increase. In the last rising rate environment in 2004–2006, deposit "betas" (the percentage of Fed Funds rate increases reflected in deposit rate increases) were lower for the initial 100 bp increase in Fed Funds; subsequent Fed Funds increases engendered higher deposit betas (see Figure 1).

The shift in deposit portfolio mix will also begin slowly, with only modest initial movements from DDA and lower yield accounts into promotional MMDAs and CDs. Both these reactions — lagging deposit rates and muted mix shift — occurred in the prior rising rate period and will repeat. In the current environment, profit pressures and lower loan-to-deposit ratios for most players should outweigh deposit growth goals on average, and hence we believe the initial deposit betas will likely be lower this time than in 2004–2006.

Second, differences in betas across classes of banks will emerge quickly, leading to hotter and cooler markets. Direct banks have a significant presence now compared to ten years ago — and their size, brand names and responsiveness foreshadow larger impacts this time. And there is a wider range of loan-to-deposit ratios among banks and credit unions; the higher ratio institutions will push up rates in their local markets earlier in the cycle. While the overall industry loan-to-deposit ratio is lower this time than last, many banks will find their Liquidity Coverage Ratio to be the new binding constraint, which will selectively put upward pressure on betas.

Many direct banks and deposit-light regionals already have aggressive deposit promotions, in some cases offering over 100 bp for liquid deposits and over 200 bp for longer-term CDs. A few of these players will likely push their promotional pricing up with a 100% beta, but others will wait it out. When and to what degree the rate increases of the direct and other aggressive banks will affect the overall deposit market are less clear, but we do not believe that will occur with the initial rate increase or two.

Figure 1: Deposit Betas for Each 100 bp Fed Funds Increase (2Q04-3Q06)



Source: Federal Reserve, FDIC, Informa data, Novantas analysis

Third, customer churn will increase. Novantas analysis of customer balance turnover in a higher rate environment points to a potential doubling of the churn currently experienced, putting upward pressure on deposit rates to minimize outflows and regain lost share. With dramatically increased customer preference for online/mobile banking (remember, there was no iPhone in 2004) and the ease of shopping online, we expect a sizeable upturn in churn, which will pressure deposit rates.

Finally, should the Fed follows its initial move with a steady stream of additional rate increases, then deposit betas will ramp up. In the last rising rate period, betas for the second 100 bp of Fed Funds increases were dramatically higher, as banks essentially priced back all of the lag realized in the first 100 bp. When rising rates attract more visibility — especially from online/mobile sources — banks will find it difficult to maintain growth without offering a top quartile deposit rate. Hence, we expect that deposit betas for the second 100 bp of rate increases will be certainly higher than for the initial increases, and may well be higher than the equivalent period in the prior rising rate period.

WHAT SHOULD DEPOSIT BANKERS DO?

1. Get your foundational analytics in order. In order to react rapidly and effectively to competitive pressures and changing consumer behaviors, banks will need strong analytics in place. Well prepared banks realize that the value of core analytic capabilities increases as rates start moving.

Banks need to have an accurate understanding of both how the competition is shifting rates, as well as the analytics to translate these shifts into balance sheet impacts. While most banks subscribe to third party competitor rate feeds, they need to ensure they are translating that granular data into actionable metrics. That means both distilling competitor moves into references rates that drive the portfolio, and distinguishing between flows that are comparatively immune to rate differences (e.g., retention) versus flows that are more at risk (e.g., acquisition).

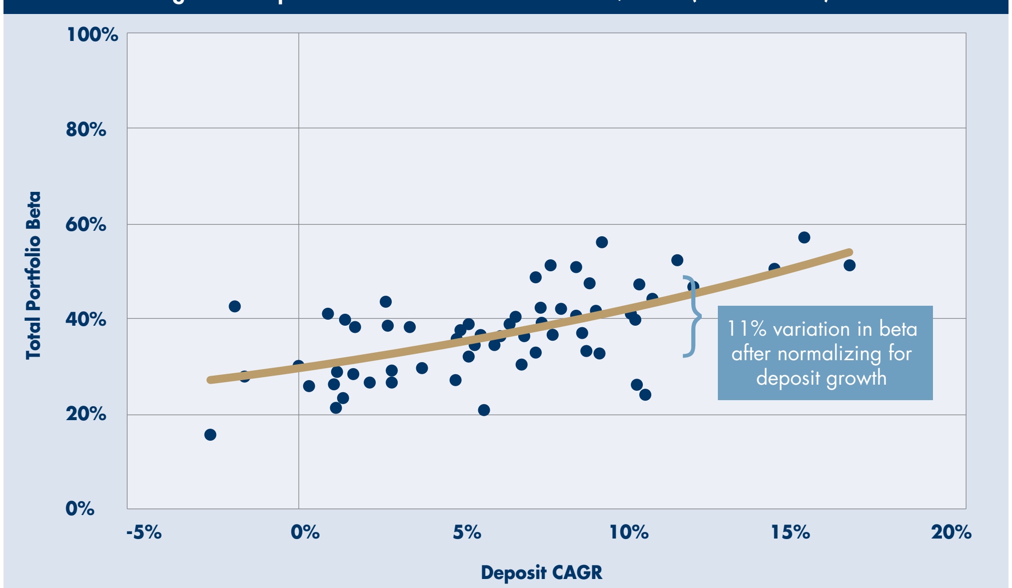
Banks must also monitor their own customers as closely as they do competitor rates. We are expecting an increase in balance movement velocity, which will make it more important to understand by customer segment which balances are moving between products within the bank versus moving out of the bank. This will require not only customer level analytics, but also the business intelligence to identify changes in customer behavior and the prescriptive analytics to model how best to respond with rate.

2. Develop contingency strategies — prepare now or pay later. Given uncertainties around the next rising rate environment, a number of banks have proactively planned for alternate scenarios. Better-prepared banks have a good view of their base case growth strategy and tactics, as well as the largest potential disruptors to that case and specific tactics to mitigate such disruptions. And these banks have assessed their ability to quickly execute these forward-looking plans — analytically and operationally — before changes in market conditions become acute.

Banks must also identify what is likely to be different this time from the last rising rate environment in their markets, and assess their potential impacts on growth and betas. One glaring concern this time comes from the large potential threat of direct banks with disruptive rate offers. Separately, what if larger-than-planned commercial deposit runoff places pressure on the bank's (or competitors) retail deposit base to make up the shortfall? What if customers shift balances to higher yield CDs more quickly? What if more customers see and shift from low-rate to promo-rate products? Will readily available and transparent rate information dramatically increase customer shopping frequency? Novantas modeling found that the impact of these scenarios can result in 2–8% higher industry betas, with larger impacts for deposit-needy banks.

After identifying likely and alternate scenarios and potential differences from prior patterns, banks will then need to determine what strategies and tactics they will use to reach their deposit growth and margin objectives. Clearly, individual bank betas rise as their deposit growth targets rise (see Figure 2). However, in the last rising rate environment, betas varied by 11% after correcting for deposit growth, showing the difference between more and less effective pricing tactics. Given the importance of keeping betas low, deposit bankers will need to ask themselves how

Figure 2: Deposit Growth vs. Beta for Banks >$10 bil (2Q04–3Q06)



Source: FDIC, SNL Financial, Novantas BranchScape, Novantas analysis far they can push traditional strategies such geographic promotional pricing. At what point might fatigue set in and returns diminish? How will the bank react to market CD rates being above its internal FTP credit rate? What other strategies and tactics is the bank willing to undertake if their initial plays lose effectiveness?

Finally, banks will need to evaluate their operational capabilities to ensure they can implement their standard and backup strategies in a timely fashion. Some banks are getting ahead of contingencies by deciding: What product types will be most effective under different scenarios? How long does it take to develop a new product, and are there "skeletons" that can be used to develop products faster? How should regional targets change midyear if some markets become considerably less expensive than others? Is having a separate high-rate direct bank an effective safety valve? How will changes be communicated to front line staff and customers?

While rising rates will likely provide some profitability relief to most banks, moving from basic relief to maximizing returns will require careful planning to ensure smart, fast and flexible responses to changing market conditions. Effective analytic modeling and planning to avoid knee-jerk reactions can mean the difference between enjoying a modest beta and defaulting to uneconomic hot money alternatives.

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