NOVANTAS STRATEGY & MANAGEMENT

To strengthen the composition of deposit portfolios, leading banks are refining deposit pricing strategy for major customer groups.

Core Deposits: Pricing for Retention and Expansion

BY RICH SOLOMON, SHERIEF MELEIS AND STEVE TURNER

At a time when the industry is carrying less than $80 of loans for every $100 of deposits, banks clearly have a current excess of deposit funding. Yet indiscriminate cutbacks could upset valuable customer relationships and weaken the overall posture of the retail deposit portfolio in a potential scenario of rising rates.

This dilemma is swinging the industry emphasis to core deposits, the "sticky" long-term balances that come from loyal customers. Both in culling today's portfolio and in fortifying for tomorrow's potential rising rates, core deposits are a top priority.

One problem, however, is that many banks are not able to target their rate offers in a way that lowers interest expense on marginal accounts but still minimizes the impact on steady long-term customers. Broad rate cuts designed to lower interest expense, for example, have backfired as valuable long-term customers yanked their relationships.

In other instances, aggressive rate promotions for introductory offers mostly attracted single-account customers, most of whom will likely take their balances elsewhere when the premium rate expires. This is the deposit equivalent of adverse selection, where promotional pricing largely attracts the "hot money" crowd that continually chases the next top offer elsewhere.

Given these widespread challenges, the bank with the information to accurately target longer-term balances is at a considerable advantage to the competition. This is why the new frontier of deposit pricing strategy has moved to the level of customer segment responsiveness, which is critical at a time when margins are under extreme pressure and the economy inches closer to a climate of rising rates.

AS SEEN IN BAI Banking Strategies

Each major customer group needs to be explicitly understood, not only from a market pricing perspective, but also from the standpoint of probable balance duration, a critical factor in funds transfer pricing (FTP). Considerations include the nature of the customer relationship with the bank; estimated sensitivity to rate changes; expected duration of balances; and likely receptivity to other offers (such as rewards or cash incentives) that will foster balance formation on advantageous terms.

Using such segment-based building blocks, the bank can fashion a composite rate and offer strategy that will be far more effective in managing tradeoffs between customer rate sensitivity and probable balance duration.

ADJUSTING FOR SEGMENT DIFFERENCES

Among current deposit customers, there are marked differences in rate sensitivity, both for new balances and current balances:

Inherent loyalists, for example, are strongly oriented to a particular institution and are simply looking for "fair" rates. They tend to build and maintain long-term balances on the strength of non-price factors such as convenience; service; and simply habit. While these customers are not the first destination for rate-based offers, their fairness sensibilities must be kept in mind so that loyal balances are retained as the bank promotes offers with other customer groups.

Rate-sensitive loyalists are also strongly oriented to their bank, in terms of maintaining current balances, but they still keep an eye on market rates when deciding where to place new balances. Targeted rate promotions can work well with this "situationally elastic" customer group, providing an attractive opportunity to gather balances that likely will remain with the institution after the promotion expires.

Finally, *rate surfers* base all of their decisions strictly on price. They only open accounts in instances where a bank is offering the top rate in the market, and they actively shop maturing balances and leave when rates fall. Rate surfers turn to the bank to fulfill product orders and typically do not have an in-depth relationship with the provider. This is the primary crowd attracted by aggressive promotional offers, which is why such offers are of limited use in meeting long-term funding needs.

By categorizing customers in this way, leading players are able to more precisely assess the value of deposits in each customer segment, along with the implications for internal financial management and funds transfer pricing. Leaders can then refine the go-to-market deposit pricing strategy for each major customer group.

> "Segment-based building blocks . . . will be far more effective in managing tradeoffs between customer rate sensitivity and probable balance duration."

This segment-based approach unlocks opportunities to better understand and improve the economics of today's portfolio, and also to build a strong deposit base in anticipation of potential rising market interest rates.

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