

To manage conflicting priorities, adept banks are parsing deposit strategy into a segment-by-segment exercise, based on the composition of the customer base.

Deposit Strategy: Tighten for Today or Reposition for Rising Rates?

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Banks are facing growing tension with deposit pricing strategy. Should they deemphasize balance formation at a time when the industry is awash in funding, or should they take early steps to build core funding in anticipation of potential rising rates?

The stakes are high as banks consider their options. On the one hand, there is enormous pressure to shore up current earnings. The industry is facing a potential \$50 billion annual revenue shortfall compared with pre-crisis levels. In addition to slack consumer credit growth and a margin-crunching environment of low rates, fee revenues are being hit by Regulation E and the Durbin Amendment. Also, Regulation Q will oblige banks to begin paying interest on business checking accounts.

Combined with the fact that the industry has seen loans fall to less than \$80 of balances for every \$100 of deposits in a few short years, these factors argue for shrinking the deposit portfolio in the near term. Lacking a way to profitably deploy all deposits into earning assets, bankers are tempted to further reduce rates to shed accounts.

On the other hand, a strong deposit base is vital for banks to succeed in the long term. First, deposits play a major role in attracting and retaining retail banking customers – Novantas research suggests that the majority of consumers still define their primary banking relationship based on the location of their core deposits. Second, deposits provide critical fuel for growth as the market recovers. Third is intensifying regulatory pressure to maintain high levels of core deposit funding, further elevating its value.

Ideally, banks in this situation want to realize a near-term earnings lift while retaining their franchise customers. That is, they want to identify where they can lower rates to bleed off marginal accounts while minimizing the effect on steady long-term customers. The

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bank with the information to accurately separate these groups and take effective action with each is at a considerable advantage to its competition.

Analytically adept banks are deconstructing deposit strategy into a segment exercise based on customer behavior. There are many factors to consider in developing customer behavioral segments, including variations in demonstrated customer loyalty; relationship value; price sensitivity; range of product usage; and transaction patterns in account usage and balance formation.

By studying customers in this way, leading players are able to more precisely assess the value of deposits in each customer segment and the implications for internal funds transfer pricing (FTP). Leaders can then refine the go-to-market deposit pricing strategy for each major customer group. This segment-based approach unlocks opportunities to better understand and improve the economics of today’s portfolio, and also to reposition customer relationships in anticipation of rising market interest rates.

For example, some rate incentives wind up going primarily to extreme rate shoppers who chase high-yield offers from one institution to the next. A far better use of rate incentives would be with targeted loyal customers who might bring even more sticky balances to the institution in response to the right tailored offer.

There are many opportunities along these lines, but they require a deep understanding of customer behaviors and the value of various deposit and customer categories to the bank.

CUSTOMER DIFFERENCES

As banks manage deposit rates in today’s low-rate market, some have experienced firsthand the drawbacks of sweeping actions and offers. Broad rate cuts designed to lower interest expense, for example, have backfired as valuable long-term customers yanked their relationships. In other instances, rate promotions for introductory offers mostly attracted single-account customers, most of

whom will likely vanish when the premium rate expires and the “hot money” crowd chases the next top offer elsewhere.

A better approach is to develop rate strategies that can be applied at the segment level, considering the nature of the customer relationship with the bank; sensitivity to rate changes; expected duration of balances; and likely receptivity to other offers (such as rewards or cash incentives) that will encourage 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 rates and balance formation.

Among established 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. They are not the first destination for rate-based offers, but their fairness sensibilities must be kept in minding when promoting offers with other customer groups.

Rate-sensitive loyalists are also strongly oriented to their bank, in terms of maintaining current balances, but 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, allowing the bank to attract balances that are likely to 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

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the market, and they actively shop maturing balances and leave when rates fall. They turn to the bank to fulfill product orders and typically do not have an in-depth relationship with the institution.

SEGMENT INITIATIVES

In the continuum of deposit pricing sophistication, leading banks already have many bases covered. Internally, their FTP capabilities include portfolio-level calculations of interest rate sensitivity; optionality; and the behavioral life of accounts and the associated liquidity premiums. Externally, their retail pricing is targeted by regional market; type of product; balance tier and account maturity. These areas may be the first place for other aspiring banks to look for early wins with pricing strategy.

Increasingly the pricing frontier is moving to the level of understanding customer behaviors, and creating actionable segments for FTP and targeted pricing and offers. Among other things, this entails an advanced ability to analyze customer, account, and transaction data; an ability to recognize salient patterns and the action implications for the bank; and an ability to apply this knowledge in the field, including inferring customer segment profiles by observed account behavior and interacting effectively with customers in the branch and with targeting marketing.

As these capabilities are put in place, the first priority is to understand the true value of each segment by understanding variations in price elasticity/interest rate sensitivity and behavioral life under stressed liquidity situations. This can increase the precision of overall funds transfer pricing, aggregated up from the segment level (this FTP will necessarily change as Basel III liquidity rules come into place).

Another priority is to comb through the current book of business and refresh the rate strategy for the “back book.” Along with relationship value, progressive bankers are taking actions to understand each customer’s overall price elasticity. In that way, the “back book” can be re-priced and optimized to improve margins with the minimal impact on balances and long-term relationships.

There are also opportunities to solicit additional balances from established customers, particularly the rate sensitive loyalists who, though initially responding because of a high rate offer, do not require constant reinforcement along those lines in order to retain their accounts. Banks need to analytically identify the account behaviors that point to this situationally elastic customer orientation, and then follow through with targeted pricing initiatives, through direct marketing and increasingly through direct negotiation guidelines with the branch and the call center.

A further goal is to refine pricing boundaries in promotional mass-marketed rates, so that rate offers succeed in attracting balances without “adverse selection,” i.e. becoming a magnet for rate surfers. To do this, banks need to understand the interplay between funds transfer pricing; customer price elasticity; and the price points that get customer attention in a competitive market.

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A fifth priority is to develop segment-targeted packages that consider the fuller range of factors that foster in-depth customer relationships and account consolidation. Many relationship customers are in fact less price sensitive, so indiscriminate price offers (e.g. a 25 basis-point CD bump) simply leave money on the table (and risk repricing the current high-margin portfolio). By contrast, sophisticated

banks are using targeting to identify specific segments and customers who warrant special offers.

Beyond price, people have very different motivations to bring more business to the bank. These factors also must be taken into account in crafting specific packages that will be compelling for the customer and constructive for the provider. Some customers value relationship rewards, for example, while others see benefit in combined statements and inter-operability (e.g. easy transfers between accounts). Still others simply need to be asked for the business.

Such differences cannot be left to chance in a pressurized era for the deposit business. The new frontier of deposit strategy has moved to the level of customer segment responsiveness, which clearly

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is needed at a time when margins are under extreme pressure and the economy inches closer to a climate

of rising rates. Each major customer group needs to be explicitly understood, not only from a market perspective, but also from the internal standpoint of funds transfer pricing. The banks that rise to this level will have a clear competitive advantage in culling their deposit portfolios in a way that best preserves valuable long-term customer relationships and balances.

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