HOW TO GET IN FRONT OF THE *Back Book*

BY ADAM STOCKTON, VLADANA ZLATIC AND ANDREW FRISBIE

It's a question that is being debated in corporate offices across the banking industry: "What should we do with the back book?"

That chunk of low-interest deposits sitting in customer savings accounts is incredibly valuable for a bank, especially as steep competition generates a wave of new-customer promotions with rates at far higher levels. But customers who have those low-yielding accounts may start looking for a better return.

"We can't just leave the back book at 0.05%" might be the argument from a CEO or retail-banking head. "Customers will get angry, the press will attack us, and our front line-staff will lose credibility for trying to justify the unjustifiable."

"But we can't afford it. The false positives will kill us," a CFO would counter, referring to the financial implications of giving a higher rate to customers who wouldn't have moved their accounts anyway if their rate stayed low.

Both arguments are credible, but banks should start addressing the issue now before rates rise further. **All banks need a proactive plan for standard, or back book, savings rates that not only considers economics, but also competition, customer value and reputational risk.**

The best approach for banks is to segment the customer base for a potential increase in the back book, offering targeted treatments to maximize impact while maintaining overall economic discipline. Banks should initiate such strategies with limited tests immediately to assess precision and customer response, tweaking the plan as needed.

BACK-BOOK IMPLICATIONS ARE CRITICAL

There's a lot more on the line for banks when they increase the back book as compared with launching a targeted promotion.

Deposits that are generated at a promotional rate above 1.5% account only for 13% of retail deposits, according to Novantas' Comparative Deposit Analytics. At the other end of the spectrum, 78% of retail deposits, totaling roughly $4.2 trillion, are still sitting at rates of 0.50% or below.

That gap between promotional and standard rates is only expected to widen as promotions rev up further, putting these lower-priced deposits under increasing pressure. At the same time, regional banks are also under rate pressure from national players. (See Figure 1).

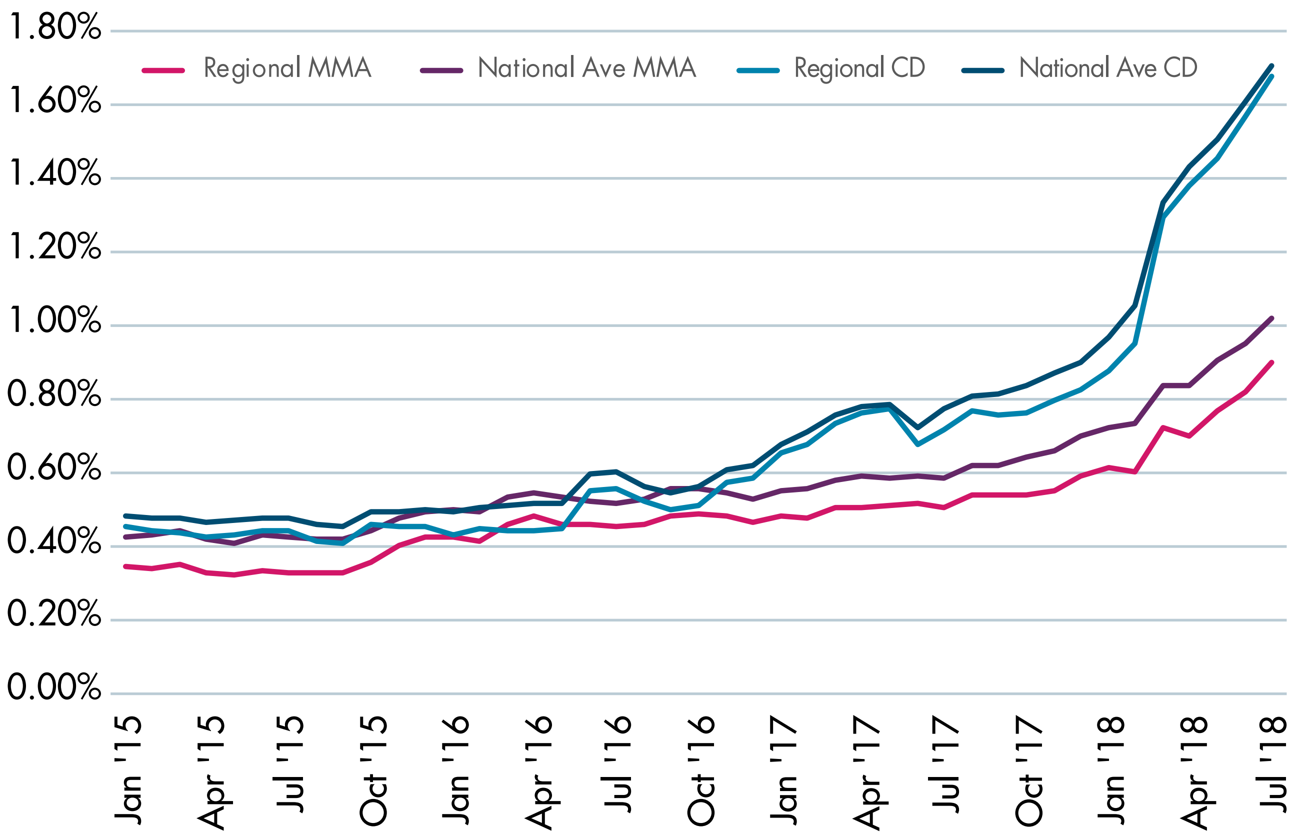
You can't blame the customer for chasing the higher rate. Indeed, banks are starting to see customers switch into promotional pricing, creating a difficult situation for front-line staff as some institutions offer promotional rates above 2.00% while standard savings can be 0.10%. Some banks are still offering rates as low as 0.01%.

THE GAP WIDENS

After four Fed-funds increases, promotional rate betas have accelerated at a pace similar to the last rising rate cycle of 2004-06. Through June 2017, the promotional savings beta for regional banks with more than $50B in assets was 15% and promotional CD beta was 37%. But from June 2017 through July 2018, the promotional savings beta shot up to 55% and promotional CD beta soared to 103% for the same set of banks.

Standard rates, however, have barely moved over the same time period. While promotional branch-based savings rates have exceeded 2.00% in half of the country and promotional 12- month CD rates often eclipse 2.50%, standard

FIGURE 1: REGIONAL BANKS LAG NATIONAL PLAYERS IN PROMOTIONAL SAVINGS AND CD RATES



Note: $50K — 99K tier, 12-17 month term for CDs
Source: Informa

rates have remained constant at rates below 0.50%, often at or below 0.10%. **The net effect is that overall portfolio weighted average rates have begun to increase, but the movement has been entirely driven by higher promotional rates and switch from standard into promotional rates.** (See Figure 2).

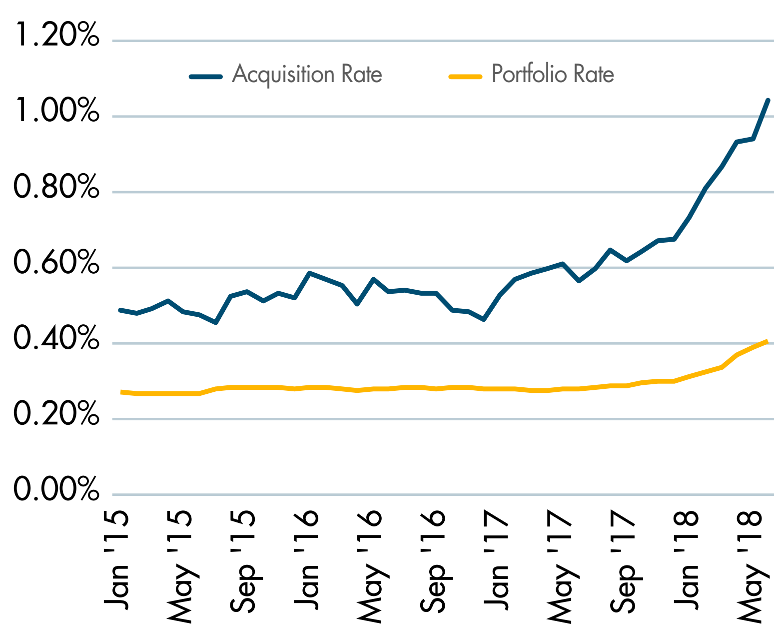
The gap will widen with additional rate increases, making it less tenable for banks to keep standard rates in place. In the prior rising-rate cycle, standard savings betas ranged from 10% for low-rate and passbook savings accounts to 30% for standard money market deposit account rates.

This leave banks with three key questions: What is at risk? When should we move? How should we move?

WHAT IS AT RISK? CUSTOMER ATTRITION AND SWITCHING

As rates continue to rise, Novantas Comparative Deposit Analytics (CDA)

FIGURE 2: RATES PAID TO NEW CUSTOMERS ARE HIGHER THAN THOSE FOR EXISTING CUSTOMERS



Note: Simple average used to protect participant anonymity
Source: Novantas CDA | Includes all products

data from 2004-06 suggest that money in motion — or churn — will ***double*** compared with activity in a low-rate environment. The prospect of switch and attrition has a large economic impact, potentially leading to a diminished net interest margin.

Already, balance switch within a bank into higher-rate products is up more than 50% in the current cycle. On an annualized basis, 15.6% of the average CDA participant's portfolio is now switching into higher-rate accounts, up from 9.6% historically. We expect switch behavior to continue to increase; data from 2004-06 suggest that **it could top out at an annualized rate of 20%.**

While switch from low-rate accounts into higher-rate accounts is increasing, the good news to this point is that **attrition levels remain consistent with historical averages.** Switch contributes to higher rates and lower NIM, but the potential damage from attrition is far more substantial — balances that leave a bank rather than switching internally are very difficult to re-acquire and may risk taking other parts of the relationship with them.

WHEN AND HOW TO REPRICE: ONE SIZE DOESN'T FIT ALL

The economics of mass repricing can be difficult — small increases in rate aren't likely to substantially change customer behavior, and large increases in rate can sink a bank's financials. On the other hand, banks can fall into a growth hole if they lose large accounts and core relationships. The question, then is when and how to reprice without damaging overall economics?

First, **detailed portfolio monitoring is critical.** Bankers need to analyze the savings behavior of their customers and tailor repricing strategies to those behaviors *(see sidebar)*. They must assess balance flows to identify which customers are switching to higher rates internally and which are leaving the bank. This also includes detailed monitoring of account closures to maintain an understanding of the full dynamics. (For example, if a checking account is closed before other accounts, it could be related to a service issue or life change. A closure of a savings account first is more likely to be rate-driven.) These dynamics must be monitored over time — both within a portfolio, and in the context of the rest of the industry.

Banks must also dissect the economics of each repricing action and compare them with other options, such as using promotions to re-acquire customers who already have left. Naturally, the economics will differ by product, potential strategy and customer segment, making targeted treatments a potentially attractive option.

Banks must accept that the decision to reprice a customer segment may generate false positives. The risk of not repricing, however, is likely to be more detrimental than handing a higher rate to customers who wouldn't have gone elsewhere. That is why it makes sense to first test a small portion of the back book, analyzing the effectiveness in retaining customers and the financial implications of the increase.

Front-line staff also need appropriate training to discuss the rate environment with customers, giving them the tools to explain to certain customers that they may be qualified for a certain rate if they take certain types of actions.

Blanket repricing may be necessary in small steps to maintain a competitive position, but the most successful banks will target elastic or high-value segments of the back book.

THE PATH FORWARD

Repricing the back book is costly and mustn't be undertaken lightly. The most effective strategies start with the ability to assess customer behavior to determine the extent of the problem. Precision segmentation that targets the most elastic and valuable customer segments, combined with continuous monitoring of the customer and competitors, will be the most effective approach. ■

Adam Stockton
Director, New York
astockton@novantas.com

Vladana Zlatic
Manager, Toronto
vzlatic@novantas.com

Andrew Frisbie
EVP, New York
afrisbie@novantas.com

SORTING OUT THE SAVER

BY ADAM STOCKTON

The ability to analyze customer savings behavior is a critical part of repricing the back book. Novantas has identified the following types of customers who are likely to respond to different pricing treatments as rates rise.

- **Continuous Adder —** Saves regularly with a consistent deposit amount over time, often through an automatic-transfer program. Withdraws with some regularity for specific purposes (vacation, debt payments), but in lesser amounts than the deposits. Has a low sensitivity to rates initially, but is at risk of attrition as the rate gap widens.
- **Disburser —** Makes infrequent deposits — typically from an annual bonus, holiday gift or inheritance — but makes steady withdrawals. Highly sensitive to rates at time of initial deposit, but pays less attention after that. Minimal attrition risk.
- **Chunky Saver —** Makes irregular and infrequent deposits, and also infrequent large withdrawals. Low initial rate sensitivity, but sensitivity increases around the time of withdrawals. These withdrawals often are driven by a search for yield when the account balance grows. This customer may be retained through targeted offers, including CDs. Moderate attrition risk.