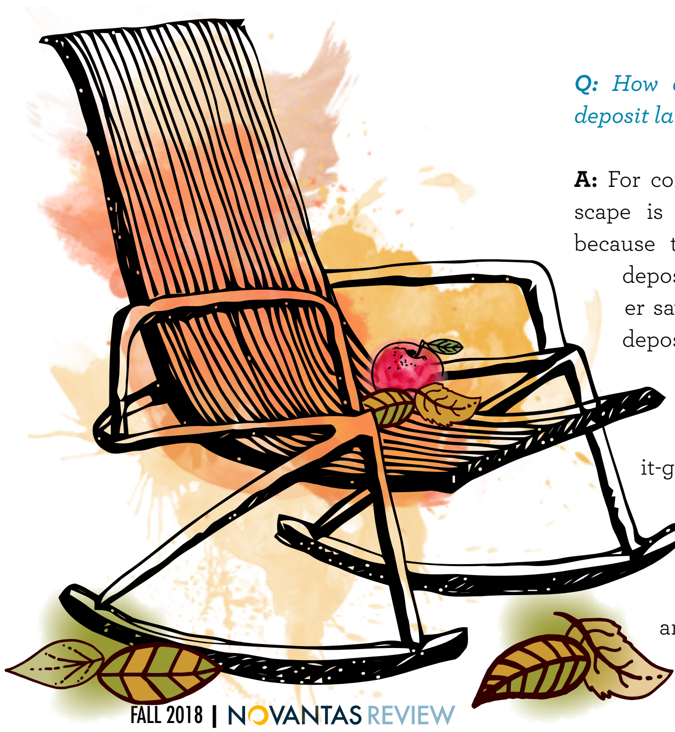
SITTING DOWN WITH NOVANTAS

BY ROBIN SIDEL

Gerard Cassidy has endured many cycles in the banking industry. The managing director at RBC Capital Markets has tracked the sector since the 1980s, asking questions on scores of earnings conference calls and issuing hundreds of analyst reports. Mr. Cassidy, who is RBC's head of U.S. bank equity strategy and a large-cap bank analyst, is frequently quoted by news organizations about the state of the banking industry. These days, he is spending a lot of time thinking about deposits and recently shared his views with the *Novantas Review*.



***Q:** How do you describe the current deposit landscape?*

A: For core deposits, the deposit landscape is becoming more competitive because these are the most valuable deposits — DDA accounts, consumer savings. Many of these types of deposits are very tough to come by and they don't grow very rapidly, so banks have not had to focus much on deposit-gathering until two years ago. In addition, the alternatives outside the traditional banking system for consumer and business money are very attractive for the first time over in ten years. Money-market mutual funds, for example, have made the landscape much more competitive than it was five years ago.

***Q:** What did second-quarter earnings tell us about the current state of deposits?*

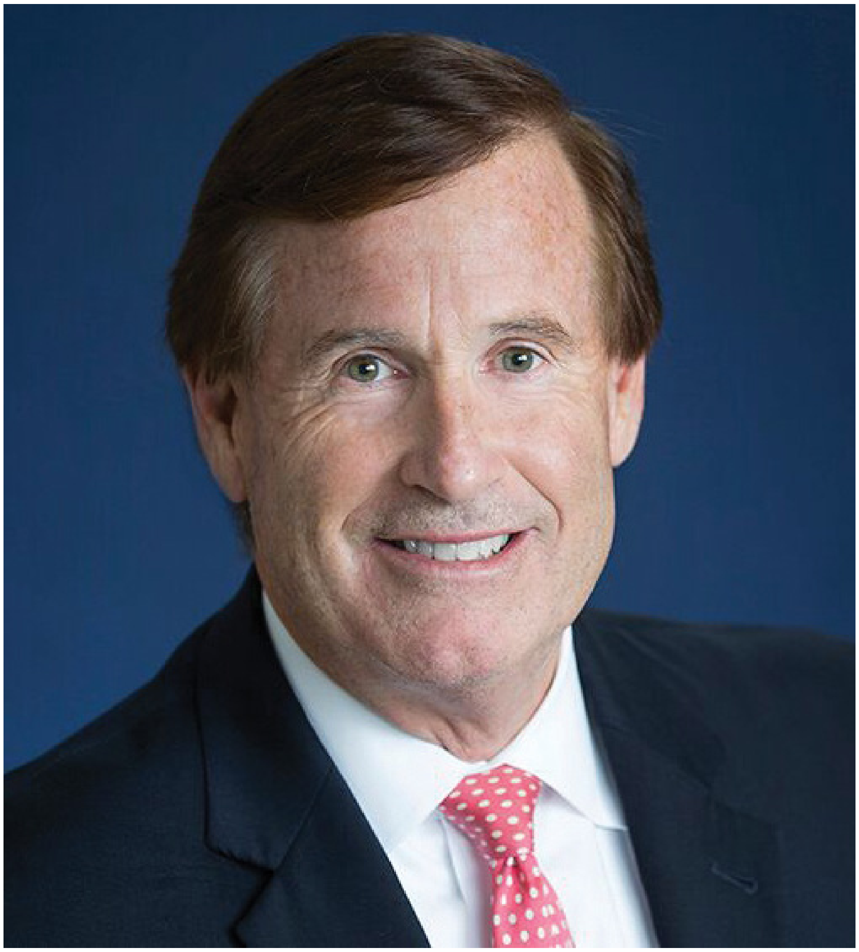
A: The second quarter showed that rising interest rates, which have been quite slow to come into the deposit landscape relative to the asset side of the balance sheet, are starting to move up faster. The midsize regional and community banks seem to have experienced the greatest pressure on having to pay up more aggressively for their deposits. Many of these institutions have grown their assets more rapidly than the largest banks. So now they need to pay up for deposits to attract deposits. DDA account growth is going to be more difficult because people are going to leave less money in those accounts as they move their money into higher-rate accounts.

***Q:** Is this cycle different from others?*

A: What's been a little different in this one is that banks have been slower to pass on the rate increases to their depositors than in past cycles. Also, the loan-to-deposit ratio in this cycle is considerably less so there is less pressure on the biggest banks to raise deposit rates. In 2004-2006, the average loan-to-deposit ratio was over 90%. So when rates moved, banks had to be quicker about raising rates. Today, those ratios are around 75%, so there is less pressure to have to raise rates. But as rates go higher, each incremental increase in the Fed funds rate will lead to more people to thinking about moving their money around.

***Q:** Are banks prepared for rising deposit betas?*

A: They are definitely aware of what's going on and more and more of them are looking for alternative strategies to raise deposits. The new buzz is rolling out these national digital deposit strategies. They are becoming more focused on this



Gerard Cassidy, managing director at RBC Capital Markets

and looking to create products and strategies to grow deposits without having to raise rates across the board.

***Q:** What kind of impact are direct banks having on traditional institutions?*

A: What we are likely to see is there will be more intense competition in that segment of the market. In the past, we had different channels to capture that money. We had brokered CD programs where banks would align themselves with different brokerage firms and gather hot money. There have always been different channels to attract that money, and now with digitalization upon us, the banks can offer another channel to their customers. But the money is very interest sensitive. If you gather deposits because you're paying attractive interest rates, the moment you fall behind, you will lose those deposits because the money is not loyal.

***Q:** How hard is it for a traditional lender who is not in the top five to acquire valuable low-cost deposits?*

A: It has always been difficult for them and it becomes more difficult in a rising-rate environment. Low-cost deposits are the true value of any bank franchise and those deposits are becoming more valuable. They are the crown jewels of a banking franchise.

***Q:** Do banks have strategies in place for managing the back book?*

A: Right now most banks are trying to brand new product somewhat differently so they don't alienate their existing customer base in the deposit footprint. Traditionally, the way the banks try to manage not raising rates across the board is to go out with specific programs, like CDs. And now, as a percentage of deposits, CDs are growing more quickly than other deposit balances. Over time, though, they will be forced to raise rates on all deposits in order to keep them in-house.

***Q:** Some banks are now offering CDs at 2.5%. Is this a good strategy to acquire deposits?*

A: The CD strategy tends to be a rifle shot approach. We will see more of these CD offerings especially for the banks exhibiting the highest rates of growth on the asset side. But if a bank is raising money through the CD market and lending it into indirect auto, which is very competitive, it's tough to see how it could make an adequate margin on that. For the banks that are interested in growing their loan book, CDs are clearly going to be one source of funding they will pursue more aggressively.

***Q:** Are bank investors concerned about rising deposit costs?*

A: It is becoming an increasing focal point for investors. In the first half 2017, for example, deposit discussions were limited. There just wasn't much concern. Now, when you look at stocks that did well when rates first increased — the asset-sensitive names — have not done as well because investors are recognizing they are not as asset sensitive because they have to pay up for deposits. It is our belief that the banks that have the access to lower-cost deposits are the ones that will outperform.

***Q:** Have you personally sought out a higher rate in the last year?*

A: Absolutely. Over six months ago, I took a fair amount of my excess cash and moved it out of my bank account into a money-market mutual fund. With each incremental rate increase, more and more people will do that. ■

Robin Sidel
Director, New York
rsidel@novantas.com