DEPOSIT PRICING NEEDS URGENT ATTENTION AS RATES FALL

BY ADAM STOCKTON AND CHRYSTAL POZIN

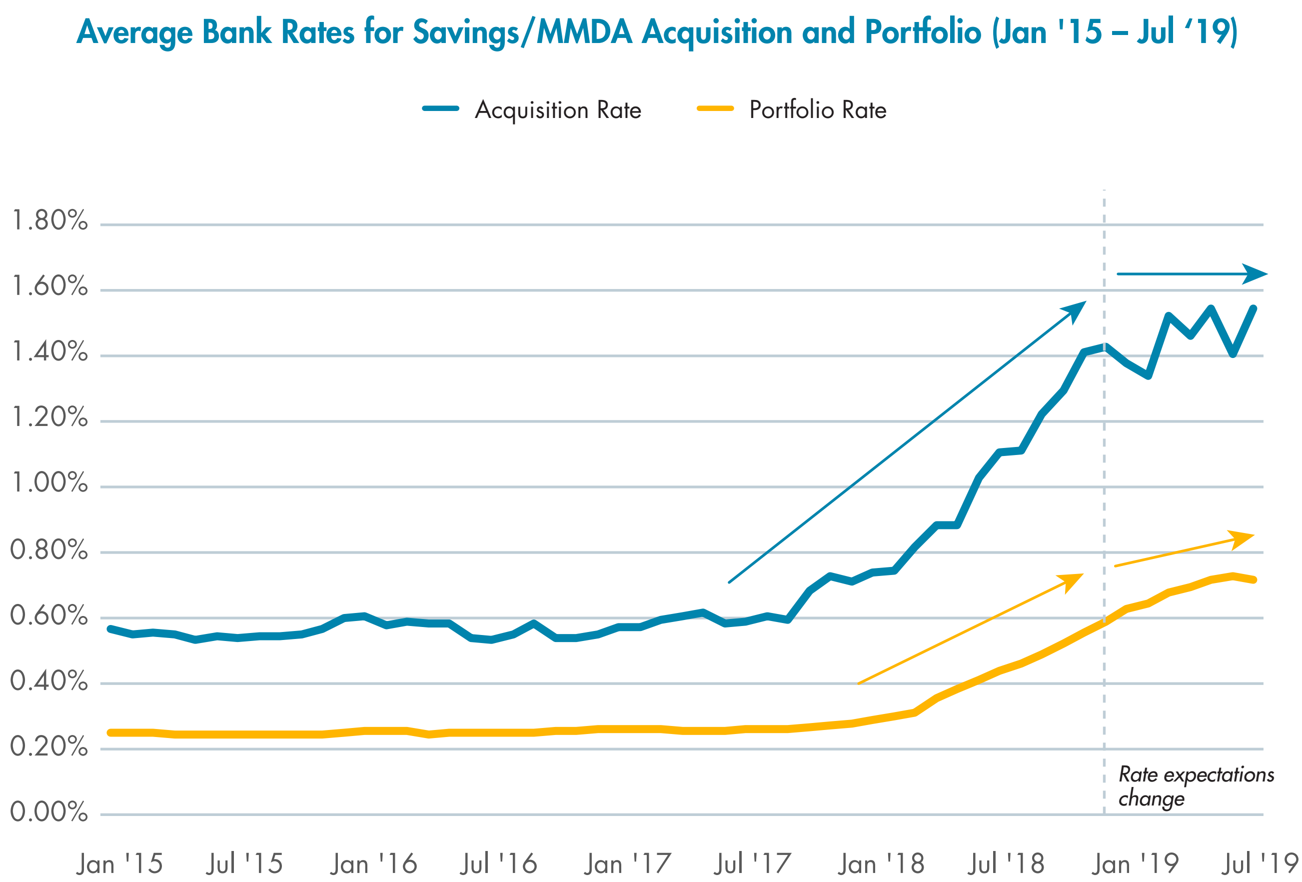
The Fed recently lowered interest rates for the first time in more than a decade, but that doesn't mean U.S. banks will be able to enjoy immediate relief from rising deposit costs.

History tells us that average commercial and consumer rates continue to rise after the initial couple of Fed reductions. As such, Novantas expects deposit costs to continue rising at least for another year, assuming no cataclysmic economic crisis. (See Figure 1.)

That's why it is more important than ever to adopt surgical product and/or relationship-based pricing programs that distinguish between rate-driven and non-rate-driven customer segments. The programs allow the bank to better match the overall cost of funds with declining wholesale rates, while still providing capabilities to selectively use rate if the bank wants to retain or grow balances.

Moving an entire portfolio or product category down at once may open up a bank to significant risk of deposit runoff or a dramatic slowing of deposit growth. Not all customers are created equal, so why treat them that way?

FIGURE 1: CONSUMER SAVINGS/MMDA ACQUISITION RATES HAVE PLATEAUED SINCE JAN '19, BUT PORTFOLIO RATES CONTINUE TO RISE



Source: Novantas Retail Comparative Deposit Analytics (CDA) Database, July'19 | Simple average used to protect participant anonymity

Perhaps more importantly, selective use of rate can put a bank in a better cost-of-funds position the next time the Fed moves up.

A DIFFERENT MARKET THIS TIME AROUND

While the current rate environment is likely to broadly track historical patterns, there are some important distinctions from the last time the Fed began cutting rates during the financial crisis.

For one thing, portfolio rates were far higher in 2007 than they are today, which gave banks a lot more leeway back then to reduce rates when the Fed started its downward move. That means retail betas will naturally be lower on the way down this time because banks maintained solid beta discipline on the way up.

More than 50% of retail savings and MMDA deposits were priced below 0.25% when the Fed cut rates in July, even as promotional rates nearly universally exceeded 2.00%. These already-low-cost deposits can't receive a 100% downward beta for even one rate cut, capping the maximum downward retail beta.

On the commercial side, corporations shifted as much as 50% of their liquidity to banks during and after the financial crisis, up from about 25% in normal times. This gave them more negotiating power with banks.

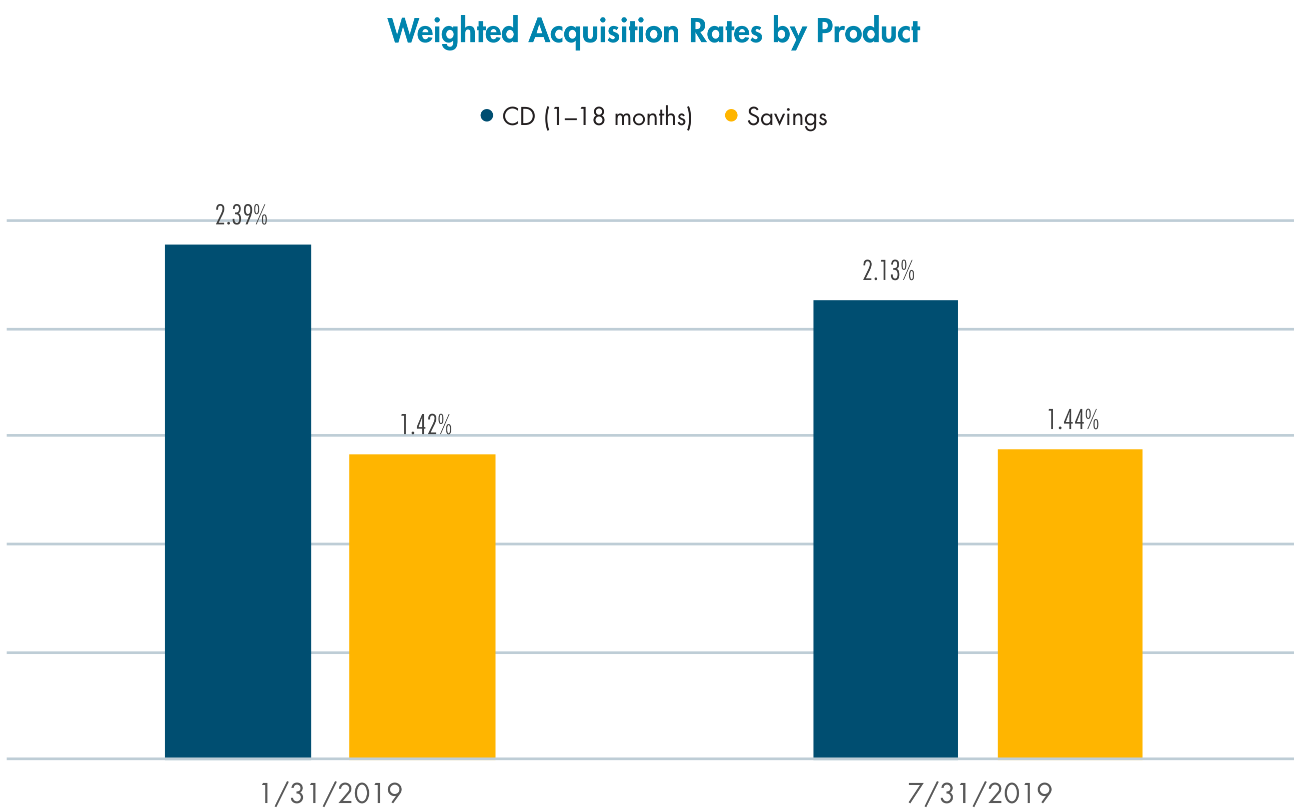
Finally, recent deposit growth has been slower for most traditional banks than it was in 2007, keeping pressure on institutions to maintain competitive rates.

In the face of this competition, a number of regional banks began collecting out-of-footprint deposits, either through a distinctly-branded direct bank or through high rates offered only to customers outside the bank's traditional geographic area. The resulting increase in online competition has trickled into local markets, widening the competitive dynamic more than in the past.

WHERE RATES ARE BEING CUT

The July rate cut wasn't on the horizon in mid-2018 when banks were planning and budgeting for 2019. Indeed, many

FIGURE 2: ACQUISITION RATES FOR 1–18-MONTH RETAIL CDS HAVE BEEN FALLING, BUT ACQUISITION RATES FOR HIGH-YIELD SAVINGS/MMDA HAVE HELD STEADY



Source: Novantas Retail Comparative Deposit Analytics (CDA) Database, July'19

bankers thought rates would keep rising. As a result, banks are now scrambling to revise the strategies they put in place when rates were rising.

Some banks, particularly direct banks, started trimming retail CD and savings rates this summer before the Fed announced its rate cut in July. This was triggered by both an expectation of a Fed cut and the flattening of the yield curve. (See Figure 2.)

In commercial businesses, some early cuts were based on the value that the client brought to the bank. Bankers told Novantas that they received little pushback from these clients, especially when they received a detailed explanation of why the rates were being reduced. (See Figure 3.)

Banks continued trimming rates at a fairly muted pace after the Fed cut rates by a quarter-point on July 31. Though many of the largest direct banks cut rates aggressively, the top retail direct online savings rates didn't change at all from the beginning of the year through the middle of August. While many banks earned some deposit-cost relief, downward deposit betas have been nowhere near 100%.

HOW TO NAVIGATE THE NEW RATE ENVIRONMENT

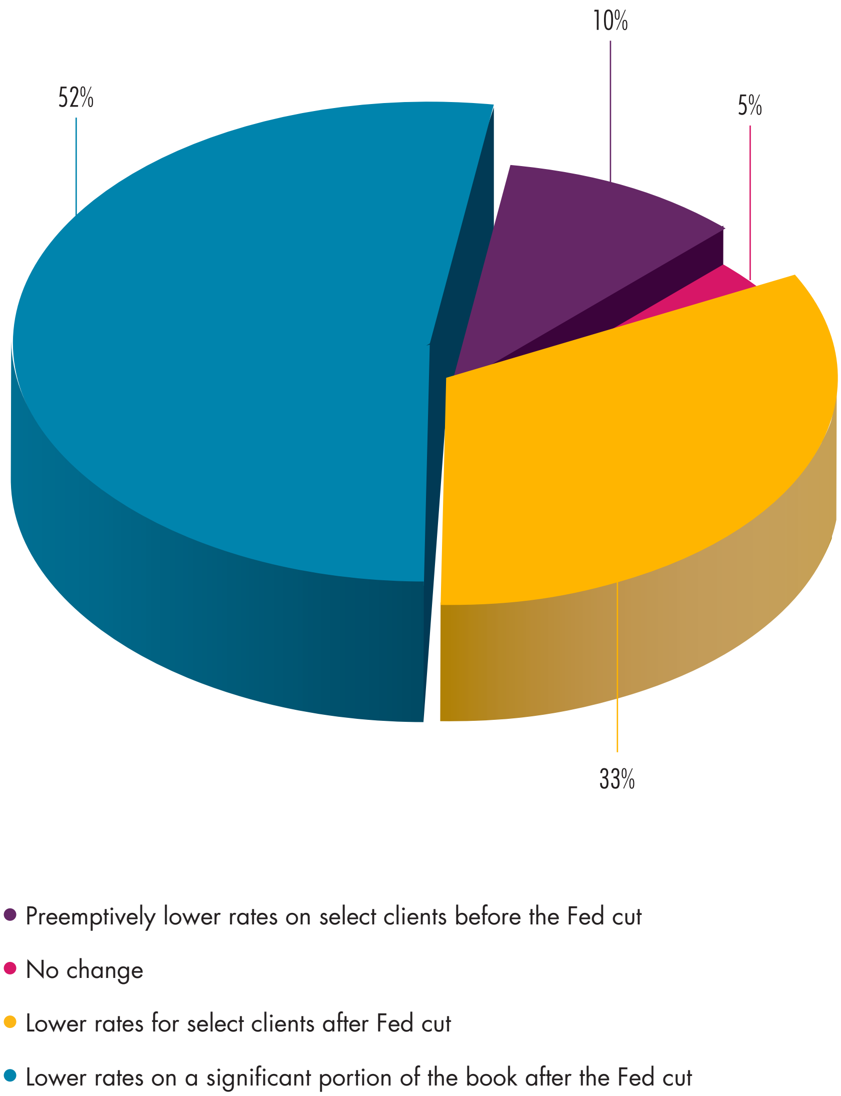
Unlike the last cycle, better business intelligence can now help banks plan for multiple scenarios, pivot quickly and communicate changes rapidly to clients. Banks shouldn't allow themselves to be caught flat-footed again by shifting macroeconomic forecasts. As rapidly as the Fed forecast changed from October to March, it could well change again.

Winning banks plan with the "consensus" forecast in mind, of course, but they also consider multiple contingencies and set targets for each scenario with the goal of moving more nimbly than competitors.

In all cases, banks will need to consider some critical questions about their deposit-rate strategies.

First, how important is near-term deposit growth? Rate cuts can push some customers out the door, but cutting more aggressively will have an even bigger impact on acquisition rates. Is your bank willing to sacrifice beta for growth? How does your bank plan to react if rates continue to drop? What

FIGURE 3: BANKS TELL NOVANTAS THEY ARE PURSUING VARIED STRATEGIES FOR COMMERCIAL CLIENTS AS THE FED CUTS RATES



Source: Novantas U.S. commercial deposit survey, Q219, N=21

if rates flatten? While interest-expense relief is at the top of many minds, all banks will need a plan to hit growth targets in a lower-rate environment.

Second, how agile is the bank when considering rate changes? Are internal processes too bulky for the bank to cut rates quickly? Banks should respond to external price movements as soon as possible, rather than waiting for a multi-week decision process. Even 25 basis points left on the table for a couple of weeks can add up to a one-basis-point hit to annual portfolio interest expense.

Third, granular customer segmentation can help a bank make the right decisions on the way down. The ability to segment rate-sensitive commercial customers, for example, could lead a bank to reduce one customer's rate by less than others who are deemed not as valuable. In this case, it is key to communicate properly with these customers.

Fourth, analysis of customer behavior is imperative. What is driving customer movements? If growth is below expectations, is it because retail and commercial customers are pulling balances from the bank? Or are they just not depositing as much as expected? Most importantly, are clients behaving as expected? Some clients may be willing to accept a beta over 100%, while others will need to be managed down much more gradually and carefully. Some segments may even be candidates for balance-growth offers, capitalizing on other financial institutions that lowered their rates too deeply.

Leading banks are increasingly driving the analysis down to a customer level and offering more targeted treatments, especially in retail. Commercial banking historically has lagged in analytical sophistication, but there is now even greater opportunity to use analytics instead of instinct in adjusting pricing.

DECISION TIME

There's no doubt that banks will face difficult pricing decisions in coming months even if the Fed doesn't go on a rate-cutting tear. Banks will increasingly need to decide if they are playing defense or offense on rates. They must determine if the cost of retaining balances is worth the prospect of account run-off or the cost of re-acquiring those balances at a later date. These costs may differ under different competitive and macroeconomic environments, underscoring the importance of scenario analysis and strong pre-planning.

Finally, the more surgical and customer-specific a bank is, the more it can manage deposit costs. Over time, more customer-level relationship pricing will be a key tool as banks navigate the new rate environment. ■

Adam Stockton
Director, New York
astockton@novantas.com

Chrystal Pozin
Director, Chicago
cpozin@novantas.com