SURPRISE FED DROP WILL FORCE AGGRESSIVE *– BUT SURGICAL –* DEPOSIT RATE CUTS

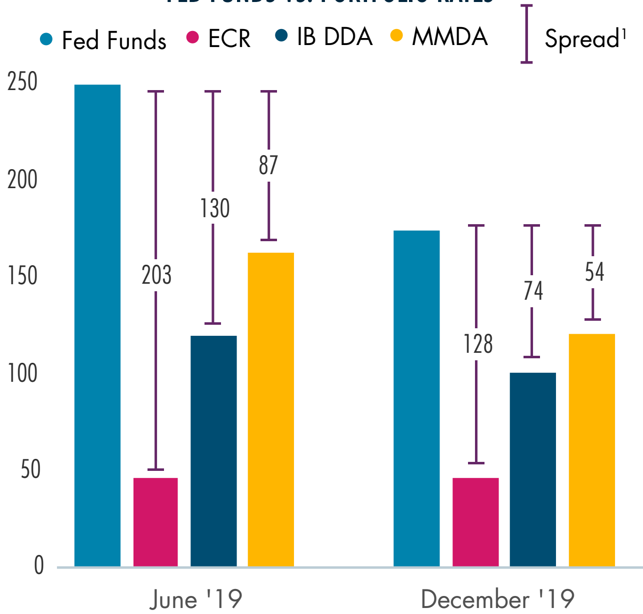
BY ADAM STOCKTON AND CHRYSTAL POZIN, WITH ANDREW FRISBIE AND PETE GILCHRIST

Today's surprise rate cut by the Federal Reserve has sent banks scrambling to minimize NIM leakage. Yesterday's plan of attack is now crumpled up in the trash can as bankers seek a new path. The unplanned 50-basis-point (bp) cut will push banks to act aggressively to reduce interest expense. At the same time, they must apply their cuts with surgical precision to retain core customers, retain core deposits and compete effectively against new digital entrants that are already challenging the status quo.

Bankers rushed to react to the half-point move. Novantas expects acquisition and portfolio deposit rates to fall broadly just as they did in 2008, which was the last time the Fed cut rates outside of its normal meeting schedule.

Novantas believes that aggressive deposit rate cuts are in order even though the economic environment today lacks the financial strain of 2008. Cuts will need to be deployed surgically, as direct bank and neobank competition won't take their feet off the gas just because the rate environment is lower.

FED FUNDS VS. PORTFOLIO RATES



[1]Spread refers to the difference between the Target Upper Fed Funds Rate and the median average portfolio rate across each ECR, IB DDA and MMDA for banks that participated in 2Q19 and 4Q19

Source(s): Novantas Commercial Deposit Study

TAKE COMMERCIAL DEPOSIT RATES DOWN

Thus far in the falling rate cycle, bankers have been stymied at broad rate reductions in commercial deposit portfolios. Many IB DDA portfolio betas have struggled to hit 20% on the downside, and many MMDA portfolio betas are stuck below 50%. Meanwhile, average FTP rates for these same products fell at a 65-75% beta, causing significant NIM compression. The Fed's sudden double move should be the impetus to take more aggressive action.

Most banks easily lowered rates for commercial customers to whom they gave high betas when rates were rising (80-100%+): these customers were, in practice, indexed to Fed funds. Downward betas should remain at or near 100% for these deposits.

Where banks struggled with rate cuts was for the "middle" customers – those who received moderate betas on the way up, but were not receiving top-of-market rates. The 50 bp cut, and the environment that surrounds it, gives commercial bankers sufficient air cover to lower rates – combined with analytics that can determine where moderate reductions might suffice, and where large reductions can be taken without significant risk of balance attrition.

Commercial deposit balance growth has been strong, with banks reporting 7% year-over-year growth in the fourth quarter of last year, according to the latest Novantas Commercial Deposit Study. Rate declines are typically accompanied by greater economic uncertainty, driving many corporates to increase their cash positions. Moreover, with rates coming down on off-balance sheet alternatives, customers have less incentive to seek yield in short-term investments. Granular, client-level analytics and tough conversations between the front line and clients can bring the "middling" commercial deposit rates down.

NEOBANK AND DIRECT-BANK COMPETITION MAKES RETAIL AND WEALTH MORE COMPLICATED

Elsewhere, neobanks often rely on transparency and "fairness" as part of their core value proposition, whether in retail or wealth-management segments. More and more providers offer a one product, one tier, one rate proposition. Such pricing structures put pressure on traditional banks, whose margins are fueled by the "back book" of standard-rate deposits.

The number of banks competing for deposits online continues to expand and direct-bank rates are maintaining a lower downward beta compared with their own upward beta through 2018.

Novantas analysis suggests that direct banks represent a growing share of the "reference rate" that customers have in mind when looking at branch-based deposit rates. While branch-based rates may fall after the Fed's move, banks in need of growth will still need to offer competitive rates, putting stress on the economics of deposit-gathering. Because most banks have already reduced back-book rates to below 25 bp, they must look for relief from promotional balances, which compete with direct banks.

PRIVATE BANKS: MORE ROOM TO CUT, BUT MORE CUTS REQUIRED

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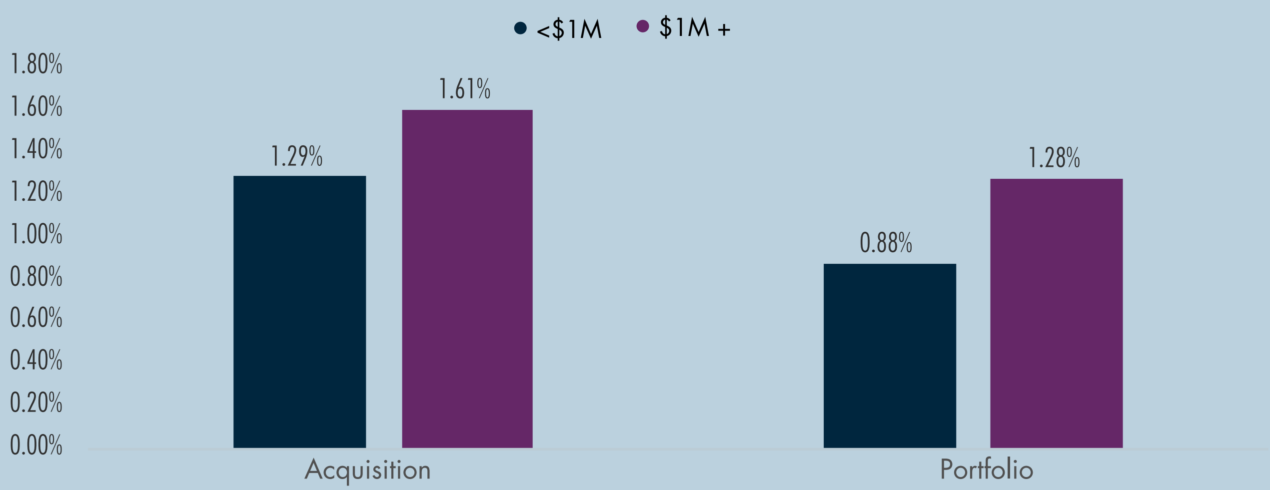
Private bankers will feel the same pressure as commercial and retail segments to reduce rates aggressively in line with today's Fed move. But the higher levels of negotiation and the extensive relationships required by these larger clients mean that selective and analytic price reductions are required.

In 2019, private banking units enjoyed double-digit deposit growth, fueled by geopolitical concerns and the decreased competitiveness of MMMFs. Sustained deposit growth has come at acquisition rates far higher than similar retail products, with higher client rates typically carried over time.

In private banking, relevant competitor or references are opaque. Clients may point to current MMMF rates or rates given by fintech entrants, but the magnitude of negotiated pricing makes the "clearing rate" for competitor banks difficult to gauge. These pricing differentials are most noticeable when viewed by tier. Novantas' Comparative Deposit Analytics (CDA) for Private Banking data reveal clearing rates for balances in excess of $1 million are often 20 bp higher than for balances below $1 million.

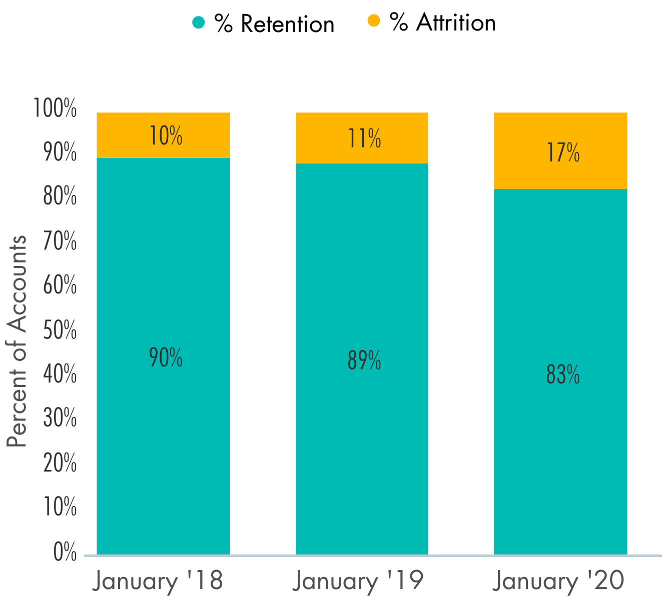
Because private-bank deposits are priced at a premium to retail, there is more room to lower rates to accompany a Fed rate cut. But such cuts should be made analytically, based on competitive insights and the client's behavioral dynamics. This is particularly important since these clients typically represent large relationships.

PRIVATE BANKING SAVINGS/MMDA RATES | DEC '19



Source: Novantas Comparative Deposit Analytics (CDA) Database, Novantas PriceTek, Novantas Analysis | Simple average used to protect participant anonymity

BRANCH 12-24 MONTH CD ROLL BEHAVIOR AT MATURITY JAN '18 – JAN '20



Source: Novantas Comparative Deposit Analytics (CDA) Database, Mar '20 | Branch line of business only| Percent Switch: Percent of accounts that stay within the bank, but switch to a different term or to a different product | Percent Attrite: Percent of accounts that leave the bank altogether | Percent Renew: Percent of accounts that stay within the bank, and stay within their original term

CD RENEWAL RATES UNDER PRESSURE

Retail CD balances were already under pressure in 2019. The proportion of balances that remained with the bank declined in 2019 from 89% to 83%, according to benchmarking data from Novantas' CDA. Novantas analysis finds that the difference between the CD's previous rate, and the rates currently on offer drives CD renewal behavior.

Most banks still have large amounts of CDs acquired at higher rates in 2019. Banks should budget for lower renewal rates and chart a path to save or reacquire lost funds, but also be wary of the cost to do so. Novantas has observed cost differences of more than 1.00% in total cost between retention, proactive acquisition and reactive reacquisition tactics. The most effective banks pair portfolio-pricing strategies and customer-level targeting to manage the balance.

WHAT TO DO?

Novantas sees three steps that banks can take now to help prepare for the impact of this unexpected rate cut.

- **Act aggressively**
- **Be nimble** – track results and pivot where necessary. Put in place reactive plans to save balances and be as surgical as possible with rate decreases.
- **Develop forward-looking plans** – identify conditions to take future steps based on potential Fed and competitive moves. For example, identify optimal conditions to launch a new product, take larger client-specific reductions, or how to achieve better CD retention by scenario.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