REDUCE, BUT DON'T SLASH AND BURN COMMERCIAL DEPOSIT RATES:

Careful Response Needed after Fed Rate Cuts

BY CHRYSTAL POZIN, PETE GILCHRIST, MIKE RICE AND PETER SERENE

It is clear that commercial deposit rates will fall following the Fed's emergency rate cuts, but the initial reaction to cut them aggressively should be tempered with an eye toward the future. Commercial lines of business have unique considerations, and Novantas advocates taking a more strategic approach to pricing. Commercial bankers can focus on prioritizing balances and retaining clients. This includes positioning ECR DDA to grow and retain deposits, while lowering IBDDA/MMDA rates. They can also begin positioning rates and fee pricing for an ultra-low or potentially negative rate environment.

PREPARE FOR A POTENTIAL LIQUIDITY SQUEEZE

In the last ultra-low rate environment during the financial crisis, commercial deposit balances flooded into banks as companies sought safety and alternative investments paid near-zero rates. Annual commercial deposit growth of more than 20% was common.

While we expect deposit balances to increase initially, we don't yet know the extent of the potential economic downturn. Companies may need to deploy cash quickly to avoid financial collapse. This makes balance retention important. The big question for banks: At what cost?

Additionally, some companies have already started to draw down credit lines to build a cash buffer. (Commercial clients typically use 50-60% of their lines of credit, leaving a lot of room for drawdowns). This strains bank liquidity, especially for those that are not lead lenders.

Non-primary banks may see clients withdraw deposits and consolidate them with their primary banks. That means banks with large portfolios of primarily non-operational relationships are at greater risk, which makes retaining deposits even more imperative. We expect these institutions will be disadvantaged on margin as it will be more difficult to pass through the Fed cut to clients.

REBALANCE DEPOSIT MIX AND DO RIGHT BY CLIENTS

Banks have an opportunity to reposition ECR DDA as the lead deposit product in the ultra-low rate environment, but this requires a careful pricing and product strategy.

In last period of ultra-low rates, banks grew commercial DDA balances significantly, nearly entirely in ECR DDA. Based on the Novantas Commercial Deposit Study, DDA increased from 30% of total commercial deposits to 75% between 2008-2018. Despite Fed Funds target rates hovering at 25 bp post-crisis, banks maintained ECRs in a 20-25 bp range while MMFs were paying between four and nine bp. This helped drive commercial cash into deposits.

We see an opportunity for banks to shift commercial deposits back into ECR DDA with attractive pricing relative to IBDDA and MMDA. By offering strong ECR rates, banks can help commercial clients offset more of their fees at a time when clients are likely to see major downturns in their businesses.

As businesses manage through the economic ripple effects of COVID-19, reducing out-of-pocket bank fees via ECR or creating innovative service bundles could help provide much-needed assistance as clients regain their footing. Banks using this strategy should employ a careful and analytical approach to set ECR at the right level, customer by customer. When the economy recovers, there will also be an opportunity to ensure appropriate value exchange with consideration of both ECR and Treasury Services fee levels.

DEPOSIT ASSESSMENT FEES ARE AT RISK

Banks charge most commercial clients a deposit assessment fee, typically 14-17 bp on ECR DDA balances. Forty percent of banks also charge fees on IBDDA balances. These fees represent 10-15% of gross Treasury Management fees at many banks.

Ultra-low rates renew the focus on these fees because they become more substantial relative to the nominal rate on the account. This may pressure banks to lower this fee, resulting in revenue losses. It is important that banks clearly communicate to their front lines and, as needed, to their clients, that there are very real administrative costs associated with holding commercial deposits and that those costs must be considered. The further ECR rates are brought down, the more focus this fee is likely to attract.

These are challenging and unprecedented times. Banks will face difficult challenges managing client preservation, profit and liquidity. Still, banks can act purposefully and with an eye to the day when markets recover. This means preserving the most valuable client relationships and considering the implications of pricing actions not based solely on near-term financials, but rather on the long-term quality of the deposit base as the cycle turns.

Chrystal Pozin
Director, Chicago
cpozin@novantas.com

Pete Gilchrist
EVP, New York
pgilchrist@novantas.com

Mike Rice
Managing Director, Chicago
mrice@novantas.com

Peter Serene
Principal, Chicago
pserene@novantas.com

ABOUT NOVANTAS

Novantas is a data-driven solutions company specializing in the banking industry. We provide a blend of data, platforms and methodologies that empower banks to become more efficient and precise as they move with their customers into a digital world. Our experienced team understands banking industry evolution, advances global thinking to meet these challenges and brings the expertise and tools needed for our clients to excel.