AMERICAN BANKER
ISSUES + ACTIONS

Deposit Costs: How Long Can Banks Hold Out?

Rising short-term rates have so far been a boon for bank profitability. But technology has made it is easier than ever for customers to migrate their funds, which means the battle for highly-valued core deposits is likely to heat up. Here's a look at how bank executives plan to contend for their share of the market.

AMERICAN BANKER

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RESEARCH

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Deposit Costs: Holding The Line on Rates Is Getting Tougher

Figure 1: Respondents by Asset Size
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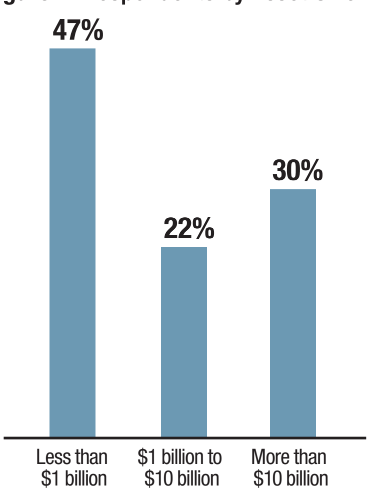

Source: SourceMedia Research, August 2017

ABSTRACT

Rising short-term interest rates have so far been a boon for banks, lifting yields on earning assets while pressure on deposit rates has hardly materialized. As of the second quarter, the industrywide net interest margin had edged up to its highest level in more than three years.

Executives have expressed surprise at the subdued movement in funding costs, but they don't expect the calm to last. During the previous Federal Reserve tightening phase about a decade ago, deposit rates were slow to adjust at first too, but the shift accelerated as market interest rates continued to increase and the case for depositors to seek higher returns became clearer.

A range of factors are poised to speed up the process even more this time. The digital revolution in banking has made it easier for customers to move money and follow the best deals. Core deposits have become even more valuable to big banks under new liquidity rules, intensifying competition for such funding. And the Fed's program to shrink its balance sheet stands to dampen growth in the supply of deposits.

American Banker/SourceMedia surveyed 283 bank executives in August to get a clearer picture of how long they think they can hold the line on deposit rates, the competitive cues they are using to inform decisions, the relative pressure they are feeling from consumer and commercial customers, and their thinking about higher levels of potentially costlier and less stable sources of funding.

Responses show that many bankers intend to stay disciplined and try to continue to resist increases in deposit rates, but that many also expect to be forced to respond if the Fed continues to tighten.

Views on the intensity of upward pressure on rates for consumers versus commercial

customers are mixed: More respondents plan to hold deposit rates steady this year for commercial clients than for consumers. But executives also say they are more likely to match competitors' rates in the commercial realm than in the consumer space.

Executives say that electronic banking has had a profound impact on the competitive dynamic, with the effectiveness of digital offerings becoming a decisive factor in the stickiness of depositor relationships, and rivals' online reach opening up a new flank for customer defections. Yet banks continue to be most attuned to local market competitors when setting rates, with 58% of respondents saying they benchmark consumer deposit prices against community banks, compared with just 7% who benchmark directly against online competitors.

And with rate increases having only just begun, according to forecasts by members of the Fed's policymaking committee, more than half of respondents say they would consider wholesale funding or brokered deposits if they fall short of targets for growth in their core deposit portfolios.

ABOUT THIS REPORT

Issues + Actions reports are produced by the editors of *American Banker* in partnership with SourceMedia Research. The reports draw upon proprietary research that probes the activities, experiences and perceptions of C-suite and other senior-level banking professionals.

The reports assess how financial services executives are responding to, and capitalizing on, the fundamental forces that are changing the industry. Each provides exclusive and authoritative analysis and insight on a topic of vital interest to the operation of a banking company. The target readership includes senior executives, line-of-business leaders, marketers and technology providers seeking deeper, more actionable industry perspectives, whether as clients or competitors. The reports are available for purchase singly or by subscription.

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KEY FINDINGS

- About a quarter of respondents say they plan to hold consumer deposit rates steady this year, and another 17% say they plan to increase consumer base rates less aggressively than the Fed. But roughly a fifth plan increases in rates on consumer term deposits and increases on consumer base rates overall in line with the Fed.

- Among respondents who do not plan to raise rates on term deposits this year, roughly 90% say they intend to hold off raising rates on longer-duration deposits until there is a more meaningful rise in long-term interest rates.

- Pressure to increase deposit rates from commercial clients has not been felt broadly.

    More respondents plan to hold deposit rates steady this year for commercial clients than for consumers.

    Fewer respondents plan to implement broad-based rate increases for commercial clients than for consumers.

    Only about 37% of respondents say their commercial customers already started trying to negotiate higher rates, compared with 63% who say they have not.

    However, respondents say they are more likely to match competitors' rates in the commercial realm — instead of simply using them as a guide – than in the consumer space.

- A significant proportion of banks are responding to changes in the competitive dynamic created by digital banking with new offerings: about 35% of respondents say they have introduced nontraditional deposit products.

- Executives report that they continue to be most attuned to local market competitors when setting rates.

- In the consumer sphere, 58% of respondents say they benchmark pricing against community banks, followed by 49% who say regional banks, and 34% who say national banks.

- Just 7% say they benchmark directly against online banks.

- About 55% of respondents say they would consider wholesale funding or brokered deposits if they fall short of deposit gathering goals over the next 12 to 18 months.

DO BANKS THINK THEY CAN HOLD THE LINE ON DEPOSIT RATES?'

Rates on deposits lagged short-term interest rates both on the way up and the way down during the last cycle. The question hanging over the industry now is: Is this time different?

With the Fed unwinding unprecedented efforts to stimulate the economy, bank executives think it very well could be. "We've never really seen this movie before," Marianne Lake, JPMorgan Chase's chief financial officer, has said. "Uncharted territory," said Citigroup CFO John Gerspach.

"The Fed has never had a balance sheet of this size. We've never been through a situation where they're talking about reducing a balance sheet," said Timothy Sloan, Wells Fargo's chief executive. "We can talk about history all day long, but since we've never been through that, nobody knows exactly what's going to happen."

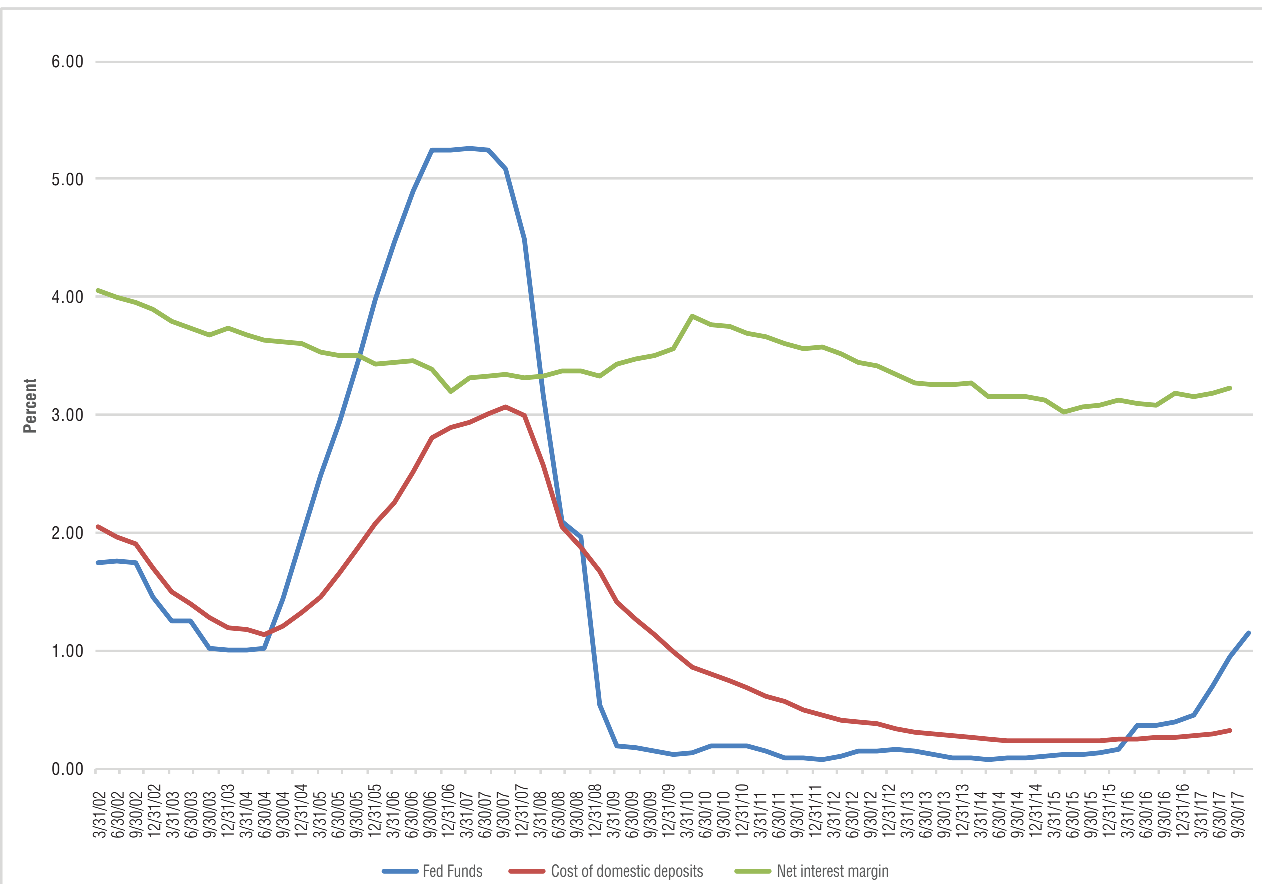
And it's not just the Fed, which has initiated a very gradual process to contract its balance sheet from its current size of about $4.5 trillion — a process that will reduce systemwide deposits relative to what they would be if the Fed instead kept its holdings of Treasuries and mortgage bonds steady. There are also new Basel Committee liquidity rules that apply to large banks and are being implemented by U.S. regulators and stand to increase competition for core deposits as a stable source of funding. Further, the revolution in digital banking in the decade-plus since the Fed's last tightening phase has made it easier to move money and transformed customers' relationships with banks. The ease with which depositors can comparison shop and open new accounts to chase better deals could force rates up more quickly.

But looking back at history is better than nothing. The Federal Deposit Insurance Corp. has estimated that more than 60% of banks across the country had a deposit beta — the ratio of the change in the rate paid for deposits to the change in the underlying market rate — of less than 20% as the central bank moved to lift the Fed funds rate by about 2 percentage points from the first quarter of 2004 to the second quarter of 2005.

That's a reassuring statistic that means that banks were, by and large, able to lag increases in short-term rates substantially before making adjustments to deposit prices. But as the Fed continued to tighten and the case for depositors to seek higher returns became clearer — and as time deposits repriced — betas increased. The FDIC estimated that more than 60% of banks had betas of more than 20% over the full tightening phase, which lasted more than two years as the Fed funds rate climbed a total of about 4.25 percentage points.

During the tightening phase now underway, bank executives have expressed pleasant surprise that betas have been lower than they expected so far. The Fed first lifted its policy rate target from its crisis-era footing of 0 to 0.25% in late 2015, inching it up to 1% to 1.25% in the middle of this year. Over the same time, the cost of funding domestic deposits across the industry has hardly budged, increasing about 0.08 percentage point from the fourth quarter of 2015 to 0.32% in the second quarter this year (**see Figure 2**), and implying a beta of just 8%. That has helped lift the industrywide net interest margin a bit, by 0.1 percentage point to 3.22% during the same period.

Figure 2: Fed funds, deposit costs and net interest margins



Note: Values for the Fed funds rate are quarterly averages of daily quotes

Source: Federal Deposit Insurance Corp. and the Federal Reserve

In July, Bank of America CFO Paul Donofrio said there has been "a lack of market pressure so far" on deposit rates. Wells Fargo CFO John Shrewsberry said, "We've seen very little market response" in consumer and small business banking deposits. Lake said, "The industry has been really quite disciplined."

Survey responses show that many bankers intend to try to continue to hold the line in the near term, but that many also expect to be forced to respond to rate increases if the Fed continues its tightening campaign.

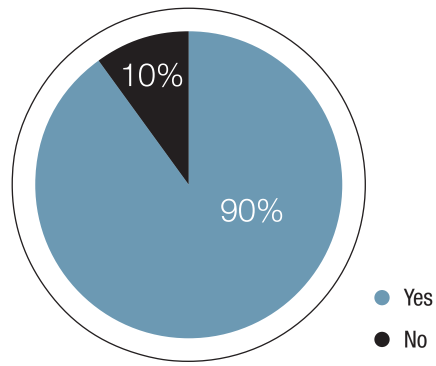
About 24% of respondents — a plurality — say they plan to hold consumer deposit rates steady this year, and about 17% say they plan to increase consumer base rates less aggressively than the Fed (**see Figure 3**). But roughly one fifth of the respondents plan increases in rates on consumer term deposits and increases on consumer base rates overall in line with the Fed.

And for respondents who do not plan to raise rates on term deposits this year, it may just be a matter of time. Roughly 90% of bankers in this group say they intend to hold off raising rates on longer-duration deposits until there is a more meaningful rise in long-term interest rates (**see Figure 4**).

In the most recent forecasts by members of the Fed's policy-making committee, the median projection for the Fed funds rate next year was 2.1%, and 2.7% for 2018 on the way to a long-run level of 2.8%.

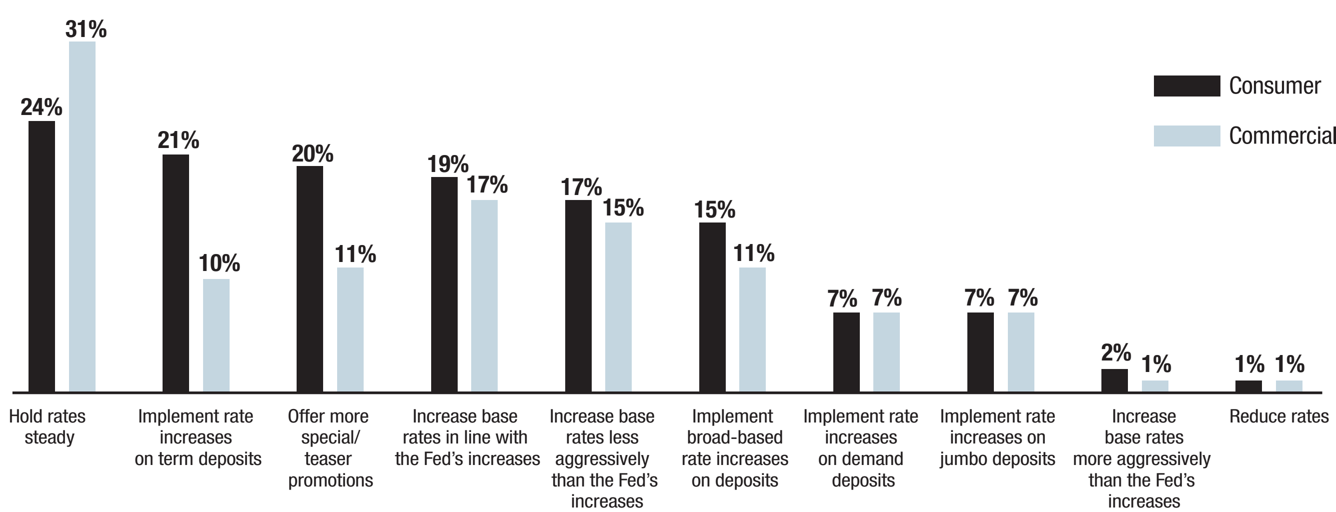
Figure 4: Do you plan to hold off raising rates on longer-duration deposits until there is a more meaningful rise in long-term interest rates?

Note: Data is for respondents who said that commercial customers have tried to negotiate for higher rates



Source: SourceMedia Research, August 2017

Figure 3: Given the Fed's apparent intention to continue raising short-term interest rates, how does your institution plan to respond this year in terms of deposit rates?



Source: SourceMedia Research, August 2017

MODEST PRESSURE FROM COMMERCIAL DEPOSITORS

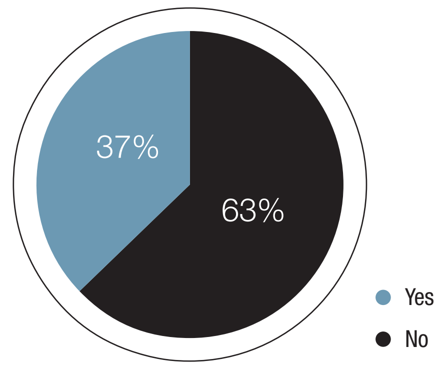
Many banks have reported that pressure from large, frequently sophisticated commercial and wholesale clients has prompted them to increase deposit rates for business accounts. "It is a tale of two cities," JPMorgan Chase's Lake said, describing the contrast with the retail business. "The wholesale price necessarily experiences higher reprice more quickly and we are seeing that pretty much in line with our expectations."

Yet survey responses suggest that the pressure is hitting a relatively narrow segment of the industry, perhaps because many banks conduct only modest business with giant depositors.

More respondents say they plan to hold deposit rates steady this year for commercial clients than for consumers — 31% versus 24% (see Figure 3). Fewer respondents say they plan to implement broad-based rate increases for commercial clients than for consumers — 15% versus 11%. Further, only about 37% of respondents say their commercial customers have already started trying to negotiate higher rates **(Figure 5)**.

Among those who report that commercial customers are pushing for better rates, however, bankers say the pressure is coming from businesses of all sizes: 43% say clients with revenues of less than $10 million have started negotiating, and 49% say the same about clients with $10 million to $500 million in revenues, compared with 19% who say that firms with more than $500 million in revenues have started negotiating. (These results could also be influenced by the share of respondents who do not do business with giant commercial clients.)

Figure 5: Have your commercial customers already started trying to negotiate higher rates?



Source: SourceMedia Research, August 2017

HOW ELECTRONIC BANKING HAS CHANGED THE COMPETITIVE EQUATION

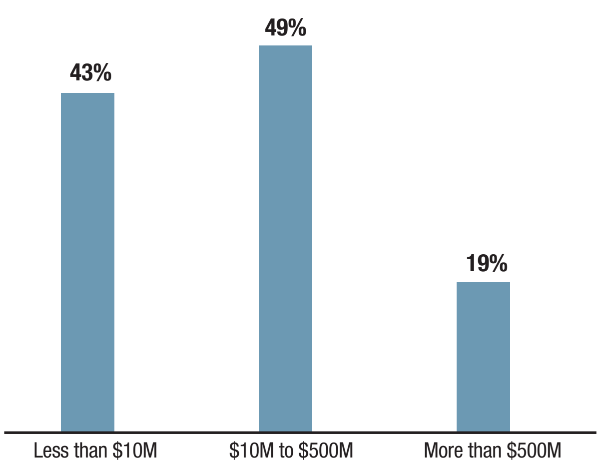
As the ability to open accounts online and easily transfer funds among different institutions has complicated the customer loyalty proposition, many banks have sought preserve depositor stickiness through new tactics and strategies. The durability of a customer relationship has become less a function of having nearby branches and more a matter of satisfaction with mobile offerings and the depth of engagement across a range of products and services.

Bank of America has said that its focus on its mobile platform has been instrumental in enabling it to reduce employee headcount and physical locations while increasing deposits, for instance, and claims that 90% of its checking accounts are its customers' primary accounts, up from 60% or 70% in years past. "And those are zero interest and they'll remain zero interest because that's the nature of the beast," CEO Brian Moynihan said.

Open-ended responses about the extent to which online and mobile banking, and the ease of online account-opening, have impacted deposit strategies

Figure 6: How large, in terms of revenue, are your commercial customers that have pressed for higher rates?

Note: Data is for respondents who said that commercial customers have tried to negotiate for higher rates



Source: SourceMedia Research, August 2017

yield similar perspectives from executives in the survey. One respondent says that "every brick and mortar institution will have to stay within a certain margin of difference" in the technological arena or risk "losing their most important customer base."

Another banker says, "We continue to focus on electronic solutions to deposit customers' needs for convenience and do not intend to add any brick and mortar locations. We will add to our electronic platform for deposit gathering and management."

Other respondents worry that their electronic capabilities are falling behind and say that, as a general matter, the digital transformation will increase the responsiveness of deposit prices to market rates. Online and mobile banking "creates a more competitive market and may force us to raise rates," one banker says.

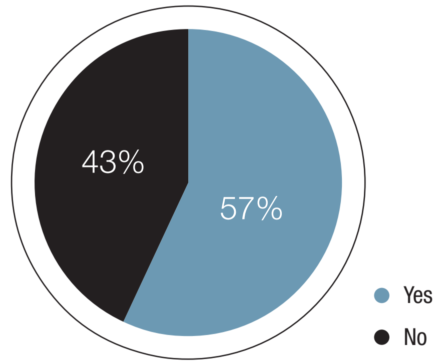
Many banks are also adding to their menu of deposit offerings, with about 35% of respondents saying they offer nontraditional deposit products. Such products include tiered interest-bearing checking accounts with rates tied to the customer's level of engagement with the bank — measured by monthly purchases on debit cards, for example — and even more novel structures like certificates of deposit with rates linked to a stock market index.

For some banks weighing offerings designed to reach niche customer segments, however, the imperative to provide a simple, easy-to-understand range of products is overriding. "There is some concern that we already have too many products on offer," says one respondent. "If anything, we will tighten up our product offerings and decrease the number of account types available."

Many banks are also seeking to connect with customers by trumpeting decisions to increase deposit rates. About 57% of respondents who say they intend to raise rates report that they also plan to introduce a new marketing campaign as a part of the move (**see Figure 7**).

Notwithstanding the erosion of geographic boundaries and physical barriers brought about by electronic banking, executives report that they continue to be most attuned to local market competitors when setting deposit rates. In the consumer sphere, 58% of respondents say they benchmark pricing against community banks, followed by 49% who say regional banks, and 34%

Figure 7: Will you introduce a new marketing campaign as part of your plan to raise rates?



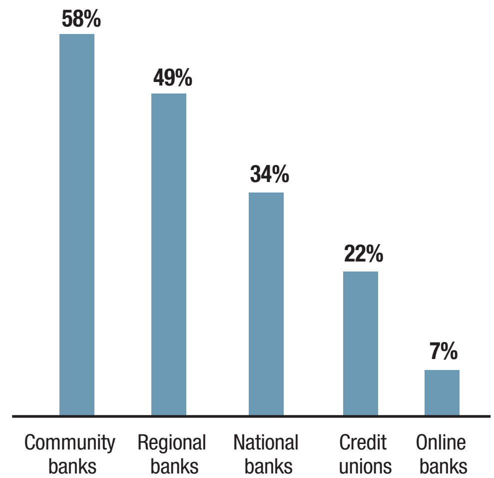
Source: SourceMedia Research, August 2017

who say national banks (see Figure 8). Just 7% say they benchmark directly against online banks.

The survey shows that competitors' prices indeed remain a primary input for decisions on deposit rates, with about 80% of respondents saying competitors' moves influence their rate setting or that they seek to match rivals in their markets (see Figure 9). Notably, respondents say they are more likely to match rivals in the commercial realm – instead of simply using competitors' prices as a guide – than in the consumer space, a finding that fits with the view that rates are rising faster for commercial accounts as banks compete for the deposits of large and sophisticated customers.

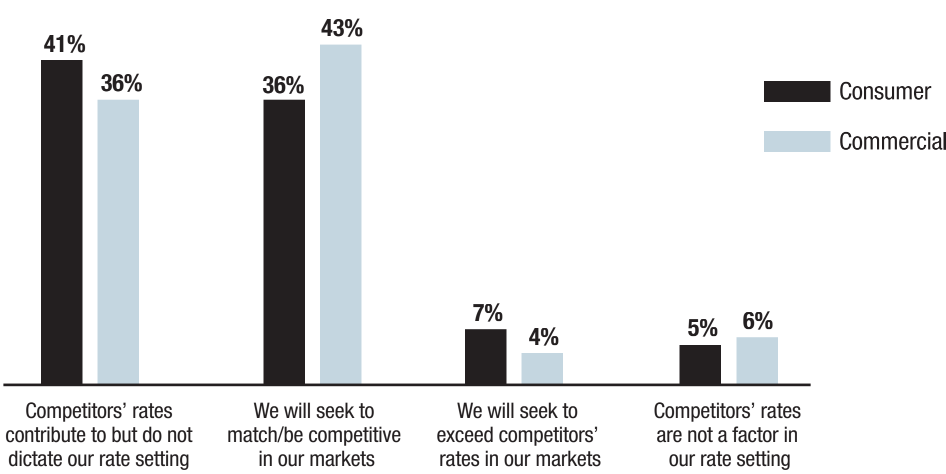
To be sure, other factors like asset and liability management imperatives are still key in setting deposit rates. Roughly 61% of respondents say they set a specific goal for net interest margin before raising deposit prices **(Figure 9)**. But the fact that 39% say they do not suggests that bankers recognize that, to a considerable degree, they are at the mercy of market forces beyond their control.

Figure 8: Specifically with respect to consumers, what kind of competitor do you take into consideration as a benchmark for where to set deposit rates?



Source: SourceMedia Research, August 2017

Figure 9: To what degree will the actions of competitors play a role in your decision-making on consumer and commercial rates?



Source: SourceMedia Research, August 2017

POTENTIAL FOR HIGHER LEVELS OF MORE EXPENSIVE AND LESS STABLE FUNDING

Heightened competition through online channels, liquidity rules that intensify large banks' demand for core deposits, and the contraction of the Fed's balance sheet raise the question of whether some banks will be forced to turn to higher levels of more expensive and less stable funding.

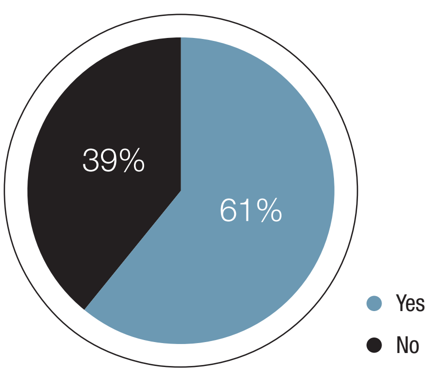
The FDIC has called attention to "generally increasing" liquidity risk at banks with less than $10 billion of assets where loans that might be hard to unload under a stress scenario are building up on balance sheets and reliance on wholesale funding, including brokered deposits, has edged higher.

While brokered deposits can form a part of a well-designed funding program, they "can be more rate sensitive than other funding sources and have substantial run-off risk after maturity if competitive interest rates are not offered," the FDIC has warned.

About 55% of survey respondents say they would consider wholesale funding or brokered deposits, if they fall short of deposit gathering goals over the next 12 to 18 months, while 45% say they would not (**see Figure 11**).

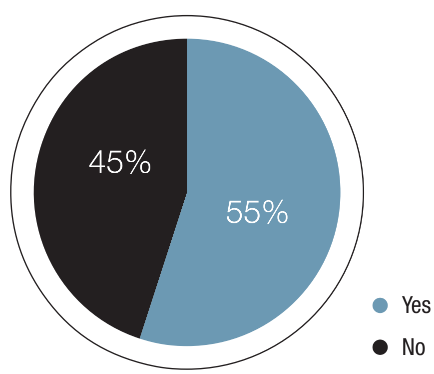
Across the industry, brokered deposits currently measure about 5.8% of earning assets, toward the high end of the range of about 3.8% to 6.7% that has prevailed for nearly two decades.

Figure 10: Will you set a specific goal for net interest margin before raising deposit prices?



Source: SourceMedia Research, August 2017

Figure 11: Will you consider wholesale funding or brokered deposits, if your bank falls short of deposit gathering goals over the next 12 to 18 months



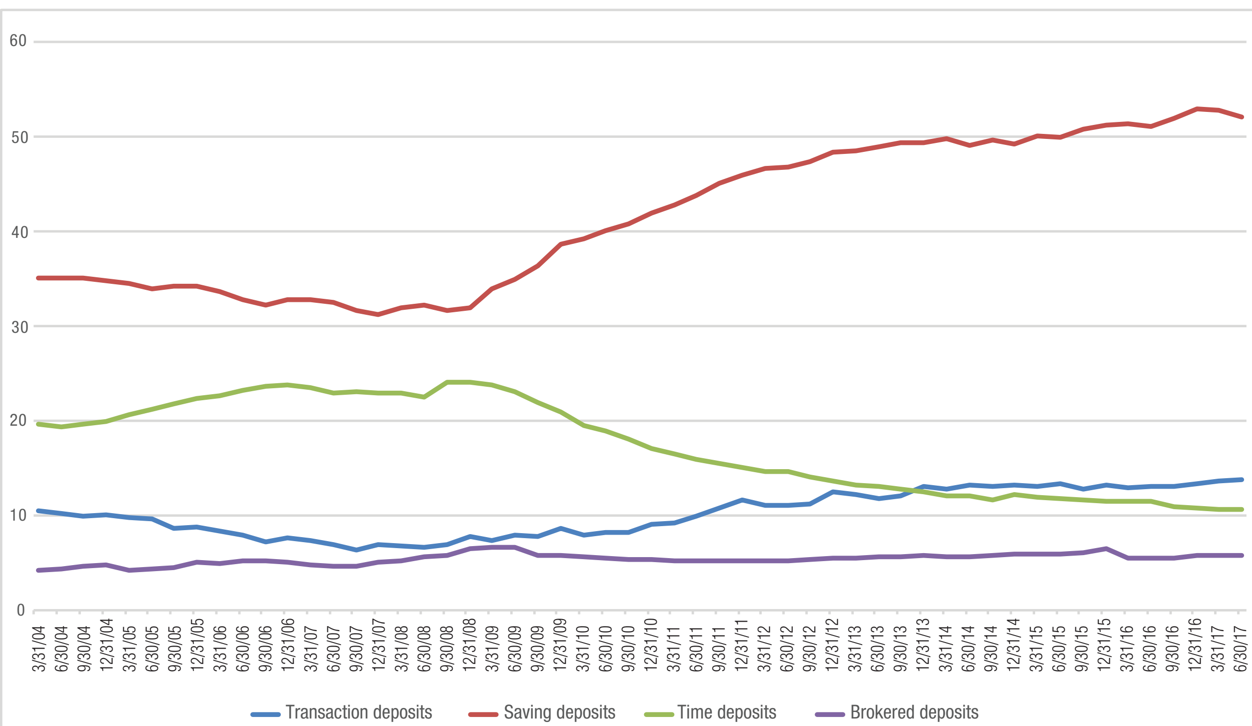
Source: SourceMedia Research, August 2017

Overall, low rates and demand for safe, cash instruments since the financial crisis has been a boon for bank funding, with the total deposits representing about 85.1% of industrywide earning assets as of the second quarter, up from 74.2% in the third quarter of 2007, just before the recession started.

Gains have been strongest in domestic savings deposits (the vast majority of which are in money market deposit accounts), which increased 20.4 percentage points to 52% of earning assets, and transaction deposits, which increased 7.4 percentage points to 13.7% of earning assets (**see Figure 12**).

Meanwhile, time deposits dropped 12.4 percentage points to 10.7% of earning assets. If rates continue to rise, money is likely to shift back from transactions and savings accounts into time deposits, helping to drive funding costs higher.

Figure 12: Fed funds, deposit costs and net interest margins



Source: Federal Deposit Insurance Corp. and the Federal Reserve

CONCLUSION: BRACING FOR MOUNTING PRESSURE ON DEPOSIT RATES

Rising short-term interest rates have been good for banks so far, but executives are keenly aware that upward pressure on funding costs is likely to mount if the Fed continues to tighten.

The strength of emerging forces on deposit pricing — such as liquidity rules that make core deposits even more valuable to large banks and intensifying competition in the digital era — is uncertain. For example, the Fed is unlikely to reduce its balance sheet to its pre-crisis size because of increased demand for reserves — in part another byproduct of liquidity rules — and a healthy global appetite for U.S. currency, and the impact of the contraction is likely to be concentrated in the market for institutional deposits.

But the direction of these forces is the same: They are poised to amplify the tendency of deposit rate increases to accelerate as underlying rates move higher.

Survey responses show that banks are trying to maintain the discipline they have demonstrated so far, but are keeping a close eye on rivals, and mindful of the altered competitive dynamic brought about by rapid advances in technology.

There are many moving parts that determine bank profitability. During the previous tightening phase, for example, the yield curve turned negative, narrowing net interest margins. But if the Fed does indeed continue to lift rates, it seems unlikely that banks will be able to escape the historical pattern of intensifying pressure on deposit costs.

[1] See the Fed's September FOMC statement at https://www.federalreserve.gov/newsevents/pressreleases/monetary20170920a.htm

[2] "Don't look now, but commercial deposit prices are on the rise," American Banker, July 18, 2017 (https://www.americanbanker.com/news/dont-look-now-but-commercial-deposit-prices-are-on-the-rise)

[3] "Wholesale funding is back in regulators' sights," American Banker, July 18, 2017 (https://www.americanbanker.com/news/wholesale-funding-is-back-in-regulators-sights)