Community Bank Views–Retail Deposit Pricing & Funding Strategies May 2019

Paul Vanden Heuvel has been in banking for over 28 years with a focus in marketing, product management, data analytics and product pricing. He has managed customer deposit and loan portfolios for some of the largest regional banks in the U.S. in addition to several community banks. Most recently, he was a consultant at an international firm where he utilized advanced consumer behavior analytics to deliver deposit pricing strategies for some of the largest international banks, large U.S. regionals and super community banks.

Retail Deposit Portfolio Themes

Managing a retail deposit portfolio is extremely challenging in today's environment. Whether the objective is maintaining or growing balances, today there are several headwinds facing banks as explained below:

- Loan Demand: Banks continue to need precious funding as loan demand remains at this cycle's peak. On average, community banks in our footprint have an aggregate loan to deposit ratio of 78% versus the prior cycle's peak of 72% in 2008.
- Client Price Sensitivity: Consumers are becoming more price sensitive and being offered lucrative deposit alternatives. The balance build that occurred in retail checking accounts during 2012-2016 is eroding as consumers are searching for yield. For example, despite no Fed move since December of 2018, the cost to acquire new retail Money Market deposits has increased 20 to 25 basis points (BPs).
- Market interest rates and the market rate for deposits: Over the last 6 months, the interest rate environment has changed dramatically. Fed fund futures are now seeking a rate cut in 2019 and forecast a fed funds rate of 1.80% in June of 2020. Currently, the front end of the yield curve is flat to inverted with effective fed funds trading at a higher yield than the 10-year treasury note. Market interest rates are declining but the rate paid to acquire or retain deposit is increasing. The deposit rate to acquire CD's, for example, has experienced a 30BP decline in rate, whereas market rates (one to three-year Treasuries) have declined by more than 75BPs.

This all poses a significant challenge to bankers as they manage their retail deposits. Bank margins will continue to shrink. Cost of Funds (COF) will continue to rise 3-5 BPs per month as consumers become more price sensitive and demand higher rates. Eventually, we may get to an inflection point where the cost of deposit growth is too high to pursue. It is now more important than ever to develop a strategy based on your bank's objectives, whether that is deposit retention, growth or revenue optimization.

Understand Your Objective – Price Accordingly

All banks are not created equal, nor do they have the same objective. Ask yourself, what are we trying to solve for: Retention, Growth, COF, Efficiency Ratio, Revenue? Pricing deposits solely based off your strongest competitor is not a strategy. Your competitor could have a different objective which may not align with your bank's unique strategy.

The key to an effective pricing strategy is to align it with your objective(s). It is important to understand what your competition is doing, but it is more important to price based on your objectives and goals. To do this, it is critical to understand the impact of rate changes, not only on deposit growth, but on revenue. Growth at any cost is not an effective strategy, a lesson we should have learned from the last financial crisis. Regional banks have mastered the relationship between rate and volume, and how to predict customer behavior and proactively manage it.

While this can be done by building sophisticated demand and elasticity models, the simple process of documenting and analyzing changes to rates and the impact it has on your bank's deposit volume and revenue might be just as effective. Analytics can help measure the impact of these changes and better align pricing to objectives. Have a plan but remain flexible.

Adapt to a Changing Environment

A common mistake banks make is managing to an annual budget without acknowledgement of the ever-changing environment. Budgets are based on the performance of the prior year and a forecasted rate environment. The ability to change and shift strategy based on the current environment is critical.

Demand for deposits is still very high and the cost of growth continues to rise at a faster pace than market rates. If this continues, banks will need to determine when to change strategy and objectives. Chasing growth in an environment with shrinking margins and escalating costs is not the only strategy. The winners in the coming years will be banks that are not married to the plan, but are willing to adapt and change, maintaining focus on optimizing revenue, and building long term franchise value.

Funding Strategies

As the demand for deposits increase, banks may be looking at alternative funding strategies. Below is a recap of various strategies we have helped employ with our clients based on our house bias for lower interest rates in the near to mid-term:

- First, funding strategy should align with growth strategy. Utilize the models mentioned above to gauge impact of any deposit retention/growth strategies.
- Begin to shorten duration on CD specials or wholesale term borrowings to reprice at lower rates over the near term.
- When borrowing is required, borrow overnight. Immediate cost may seem higher, but balance sheet fluctuations may lower number of days interest expense versus taking out term borrowings. We also believe borrowing costs will decline as Fed Funds decline.
- If not already using brokered deposits, look to mix in brokered CDs with brokered interest-bearing institutional funds through a third-party provider. This will help diversify funding sources but will likely come at an immediately higher financial cost. However, unlike "specials", brokered deposits do not introduce the risk of repricing your entire deposit base.

If you would like to learn more about any of the strategies discussed, please reach out to your CMG representative.

Erik Swanson, CFA
Managing Director
Commerce Bank
Erik.Swanson@commercebank.com

Paul Vanden Heuvel
Retail Deposit Manager
Commerce Bank
Paul.VandenHeuvel@commercebank.com

Matthew Maggi
ALM Strategist
Commerce Bank
Matt.Maggi@commercebank.com