Mistaken Indexed Deposits

by Steve Brown

Bankers that received their annual reports off the printing press, only to find a typo, know mistakes are painful. While some mistakes are minor, others can have bottom line impact. One such example that goes directly to the bottom line is the tying of deposits to a market interest rate index. While many view this as an effective marketing tool, widespread use of this product can produce earnings-destroying results. Since a majority of a financial institution's value lies in its liability structure, any element that adds more interest rate sensitivity subtracts value. Remember, to derive value from liabilities, 2 things must a occur Â– the rate must be lower than Libor and the rate must have a correlation of less than 1. By indexing CDs or deposit accounts to Libor, 3-month T-Bills or the 2Y Treasury Note, banks make these deposits almost 100% correlated to interest rate movement (usually there is a timing lag making it less than 100% correlated) Â– the exact opposite of creating value. Consider that the non-maturity deposit is the single most valuable commodity in the financial world for precisely the reason that it is not correlated to interest rate movement. If the lending side was perfectly correlated to interest rates, then the indexed deposit would be tolerable (but would not add value). However, since no institution is 100% correlated to interest rates on the asset side, indexing hurts margins in a rising rate environment, as liabilities reset faster than assets (destroying value). Banks that utilized indexed accounts give up control to affect margins as they develop cheaper liability options. Banks usually offer indexed deposits as a marketing tool to attract households or businesses that are believed to require a "market rate of interest." The reality is that these depositors seek the highest rate and rarely care about interest rate sensitivity. Survey after survey shows depositors want the highest rate and best service above all else. So why give them sensitivity? Banks would be better served by phasing out deposit accounts that are directly tied to a specific index. If a bank is required to offer such accounts, it can accomplish the same thing by building flexibility and dampening the liability correlation to a market index (maybe the goal is to be only 70% correlated?). The wholesale market (such as our brokered CD desk) can always give you market priced liabilities if you need funding (none cheaper than our callable CD issuance), however, the wholesale market does not allow a bank to further create shareholder value. As lending competition continues to increase, banks need to squeeze every spare ounce of margin out of their balance sheet in order to increase earnings. By limiting indexed deposit offerings, bankers can create a less interest rate sensitive balance sheet and help create more stable earnings in the process.

BANK NEWS

M&A

Commerce Bancshares (15.2B, KS) will purchase Commerce Bank (96.8mm, CO) for $29.5mm or about 3.35x book value.

Competition

Wachovia is offering a $25 dollar gift card to every customer that refers a new customer to the bank, and a $25 gift card to each new customer that opens an account due to a referral.

Contactless

MasterCard announced a deal with Coke to install contactless card technology in new Coke vending machines (6,000 to start) that will roll out this year.

Payday Exit

After exiting the payday loan business, First Bank of Delaware ($124mm, DE) will drop its 3rd party consumer installment loan business due to regulatory pressure. The bank will still make the loans out of its branches, but due to "perceived reputational, compliance and legal risk," will cease making the loans through its partner, Dollar Financial.

Discrimination

HUD received a record number of housing discrimination complaints for 2006. 40% of the complaints were racial in nature, while another 40% were related to disabilities.

Expanded Exams

Federal examiners put out for comment a proposal that would increase the asset size threshold from $250mm to $500mm for well-capitalized banks to be eligible for an 18-month exam cycle (provided they received a CAMELS 1 or 2 on the last exam).

Remote Capture

Comerica touts its success of its Business Deposit Capture with a press release that trumpets $1B being captured for the month of February.

A Promotion We Like

BB&T promotes its online account opening capabilities with a campaign that potential customers can sign up, log in, open multiple accounts, receive approval and transfer funds in less time it take to drive to a branch. The theme is one of the best we have seen to drive home the point of online efficiency.