MAY DAY, COUNTERINTUITIVENESS AND RATE SETTING

by Steve Brown

If you want more deposits - lower your rates. That is counterintuitive, just like the many labor unions that will celebrate the right to work today with a strike, but May Day has always been a difficult thing for the U.S. to figure out.

When it comes to setting rates for deposit classes, many bankers misinterpret the exercise to mean raising rates to attract greater deposits. To add value to an organization, the better question to ask is, "what is the minimum rate that will garner the longest duration deposits?" The outcome of that question is usually equally counterintuitive.

By raising all rates (or holding them steady after the FOMC cut), bankers end up hurting the institution by making all rate classes more sensitive. The key is to adjust rates up that will give you the most new money and move rates down for deposit products that give you the least amount of run-off.

To clarify, let's take a typical business money market account. Corporate customers may choose their bank because of an initial rate, but the reality is that most are not interest rate sensitive after funds are transferred. Money goes in an out of this type of account due to payroll, taxes, equipment purchases and a variety of other non-interest reasons. As such, why continue to pay a higher rate? In many cases, by dropping the rate, you may lose deposit balances, but not as many you might think. Most of our work in this area shows that economic value (that is net interest cost x duration x balance) is increased. Let's say we are correct that you generate greater economic value, but lower funding levels. How do you attract more funds?

Aside from wholesale sources (which is usually part of the funding solution) how else can you raise money? The interest expense you save on business MMDA accounts can now be used to attract balances in a more valuable location. Savings accounts (both business and retail) are a good place to start, as are high-tier/platinum NOW accounts. These accounts tend to be more rate sensitive, so paying an extra 20bp maybe all you need to attract additional funds.

Senior accounts are a deposit product that many banks overlook. If you don't have one and you market to retail, put one in place. Don't make the assumption that seniors are all interest rate sensitive. In many cases they are not and you shouldn't be paying a high rate. In other cases they are and a bank needs to pull these balances away from other deposit categories in order to segment the market and better control this class.

By looking at each deposit segment's history and its correlation to rates, banks can find out what accounts are interest rate sensitive and what accounts are not. Using these correlations, you can back test your findings to obtain the highest "fit." If the correlations back test well, a bank then has a good basis for projecting rates going forward. Over time, this model can be refined so that a target of 98% accuracy can be achieved.

For banks that do not have the time and resources to handle this, our Liability Coach product can help guide you in optimizing rates between products and tiers by looking at 3Ys of rate history. On average, most banks end up dropping aggregate rates while still increasing balances - a fact that is counterintuitive, but something that all bankers of the world can unite over.

BANK NEWS

Prime

The end of the month timing gave many banks pause of moving their Prime rate change to May 1, effective May 2, so that they would not have to reset down some of their loans (like HELOCs). Every national bank, however, changed their reference rate yesterday down to 5.00%, effective today.

Whistling in the Dark

The FDIC's Shelia Bair was on CNBC this morning saying that the market turmoil "plays to banks' strengths" and that current dislocations highlight the value of regulated institutions. She should find some wood to knock on.

IRS on Stimulus

Banks must market yesterday's IRS clarification that allows the Stimulus payment to be deposited directly into tax-favored accounts (like IRAs) and then withdrawn penalty free. By getting accounts to direct deposit into theses accounts, it is estimated that the funds are 70% more likely to stick around.