DEPOSIT BALANCE MANAGEMENT BY TIERING

by Steve Brown

While 2004 to 2007 was the Golden Age of Banking amid very strong credit quality, 2008 to 2012 looks like it will be the Golden Age of deposits. Never before have we seen deposit rates so low, while balances exhibit low interest rate sensitivity. To build franchise value, the goal of every bank right now should be to try and figure out how to preserve these attributes once inflation returns and rates rise.

When it comes to deposit management, understanding the interaction between pricing, product attributes and balances are central to divining sensitivity curves. Every customer, within every product, has different interest rate sensitivity and thus ideally should be priced in a customized fashion. Whether through an automated profitability system or good old fashioned tiered pricing, finding a solution can help boost performance.

Tiering, or the act of pricing deposits according to balance, is a lost art in our opinion. It is rarely talked about within banks and no longer taught at banking schools (to our knowledge). The concept is based on adjusting deposit balance distribution for a product like the one in the figure above, by placing price "breaks" at balance levels that are mathematically about 60% through the sub-distribution (there is a more complicated formula, but this is close). In other words, graphically, you want price changes just beyond each major balance spike within the overall distribution. In the structure above, this lends itself to basically 4 tiers. Like snowflakes, deposit distributions are different for every bank for every product and depending on demographics, customer focus, alternative products and basic management. Some products will lend themselves to 3 tiers (the most common), while others are 1 tier (like student accounts) or 10 tiers (like business money markets). By utilizing a formula, price incentives can be placed at points where they theoretically should do the most good by generating additional balances.

Setting tiers appropriately is only a small part of the value. Tiers also work on a passive basis, as customers often consider them when deciding what target level of balances to keep. However, that is a small part of the value in our humble opinion. The real value of tiering comes when they are utilized in sales and calling efforts. Setting tiers above the peak sub-distributions (the green lines above) allow accounts below the line to be marketed to and incented to add more balances (either by saving or by deposit transfer). Tiers set too far out of reach (like the 75% level) leave customers feeling they cannot obtain the level, so they don't try. Conversely, if tiers are set too low, customers forget about them to the point where a valuable tool is rendered irrelevant.

Over time, tiers can be migrated up in order to build greater and greater balances for the lowest cost and the least interest rate sensitivity. Banks that move their tiers around too much (such as once per quarter), however, can end up making customers more interest rate sensitive than they have to be. This is why we recommend adjusting tiers and conducting a marketing campaign no more than annually.

Like making moonshine and cheese, tiering is a lost art in America. That is unfortunate, because deposit pricing is critically important and random tiering creates operational cost and risk.

BANK NEWS

Bank Police

The Financial Crimes Enforcement Network (FINCEN) has issued a proposal that would require banks to report all international wire transfers. It is estimated the proposal could result in up to 700mm new reports per year.

Much Better

The volume of criticized loans under the shared national credit program (syndicated loans worth $20mm or more) decreased more than 30% from last year, as the severity of classifications also improved sharply. Better borrower operating performance, restructured debt, bankruptcy resolutions and improved borrower access to funding were the primary factors cited.

States Are Next

Banking analyst Meredith Whitney, who correctly forecast disaster for big US banks before the credit crisis struck, has now issued a 600 page report warning states will be next. Whitney warned states continue to spend more than they bring in and have a 27% budget shortfall as a result (which could lead to municipal bond defaults by cities and towns) and the biggest states that would drive a robust US recovery have seen revenues collapse but have not cut bank expenses enough to counterbalance (so joblessness is likely to continue in these states).

Housing Worse

S&P estimates that the principal balance of distressed homes in the US is now sitting at about $460B. Roughly speaking, it would take 41 months to clear all of that out of the pipeline, much lower than the 56 month peak hit in early 2008, but up 37% from the 30 month level it dropped down to in mid 2009 (has been rising continually since then).