SAVINGS ACCOUNT PROFITABILITY

by Steve Brown

Having just wrapped up our annual EMC Conference, we are loaded with insight about important topics from a troubled industry. By far, the most common conversation we had with community banker attendees was a similar one playing out across the Nation. It is typical of a difficult topic that high-powered professionals are dealing with every day - specifically, who is going to be on Oprah's last show. We have no idea of the answer, but we can tell you that the Queen of Media has been great and we will miss her. Our readers should understand that sometimes we regret not taking this publication in a different direction and have instead of focusing in on bank profitability; we could have focused on the well-being of our bankers and talked about their thighs, relationships and the wonder of the makeover.

Unfortunately, we don't know much about any of those topics, so we will stick to bank profitability. While not likely a topic for Oprah today, we want to focus on savings account profitability. Ironically, the account that should have the highest profitability in the bank is often the most unprofitable. The main reason is because of rate. This is simple enough - banks that pay a high savings rate, say above 1% in this market, are likely to attract a rate sensitive customer that has shorter duration and greater negative convexity than other depositors. Here, instead of a duration of 6 or 7, the savings account will shorten to only 1-2. In other words, paying a high rate now not only erodes current profitability, but also future profitability.

The impact of paying a high rate on savings is nothing new and fairly straightforward. However, next to rate, the 2nd most common reason why savings accounts are unprofitable is because bankers forget to utilize tiering. About 70% of community banks tier their savings accounts, but those that don't end up increasing aggregate interest rate sensitivity.

Let's say, for example, you want to pay an average rate of 0.65% on savings accounts. In total, because of the higher than average rate, combined with a likely costly branch network, this account is probably not profitable. In fact, in this case, the profitability is about -15%.

In this typical example, one of the ways to make this account profitable is to go to a dual account structure with multiple tiers. Here, we would suggest a lower cost "Statement Savings" - type of account that pays higher interest above $100 in 3 tiers with breaks at $1,000 and $3,000. In addition, we would then introduce a "Performance Savings" account that had 4 tiers starting at $5,000 and going to $75,000. While the straight average rate might still be 0.65%, because of the distribution for the tiers, the weighted average rate drops to 0.41%. In addition to a lower effective rate, the account structure gives depositors greater incentives to use the account and increase balances. In other words, tiering not only lowers the average cost, but it better matches rate to customers that deserve it based on value. This has the impact of increasing duration and convexity, making the account perform better over both rising and falling rate environments. The net impact of this account makeover is that profitability shifts from a -15% to a positive 18%. A healthy change that even Oprah could get behind.

While we will miss the Talk Show Guru on network TV, luckily she will be sucked into the Rapture that is cable TV. This will hopefully continue to give us inspiration - just in case we wanted to start talking about ways bankers can look better under harsh branch lighting. Until then, rest assured we will keep focused on bank profitability.

BANK NEWS

FDIC Report

The FDIC released 1Q results for the industry and key takeaways include: banks posted their highest quarterly earnings since the beginning of the financial crisis; provisions fell 60% from a year earlier; NII fell 3% from 1Q 2010 (only the 2nd time in the 27Yrs that banks reported a year-over-year decline in quarterly net operating revenue); assets climbed 0.7%, but loan balances fell 1.7% from the prior quarter (the 5th largest quarterly decline in history and the 10th time in the last 11 qtrs); the number of institutions on the "problem" list grew from 884 to 888; the biggest declines in loan balances came in residential mortgages (down $63.8B), credit cards (down $38.9B) and real estate construction and development loans (down $25.9B).

Core Banking

Fed Governor Hoenig gave a speech where he said banks should be "restricted to the core activities of making loans, taking deposits and other activities that do not significantly impede the market, bank management and bank supervisors in assessing, monitoring and controlling bank risk- taking." Hoenig proposed two new rules that would require money market mutual funds to have a floating net asset value and allow lenders that finance shadow banks to liquidate mortgage debt used as short-term collateral in the event of default (rolling back a change in a 2005 bankruptcy law).