REVERSE AND SMILE DEPOSIT TIER STRUCTURE

by Steve Brown

Many banks are swimming in deposits and concerned with capital, FDIC charges and maintenance expenses. The reality is that many banks in the industry would be more profitable if they moved these deposits off the balance sheet or otherwise invested them. Step one in this endeavor is to decide how much in earnings might you want to sacrifice on behalf of target customers. If your bank is a firm believer that every customer and every customer dollar should be at your bank despite profitability, then this tactic isn't for you. However, if you will consider managing customer balances to improve profitability, then consider changing your deposit tier structure. While few other investment alternatives work well, utilizing a traditional dynamic sweep has limited appeal. Unfortunately, banks are cornered into making hard choices and one option to consider is a reverse tier or "smile" structure for deposits. For the average bank, higher balances tend to earn a "positive" or "increasing" reward of higher rates, lower fees or more services. Thus, customers might earn 5bp on the first $10k, while amounts from $10k to $25k would earn 25bp. Normally, the objective of the tiering is to dampen interest rate sensitivity, elicit more positive convexity and drive deposit balances higher. However, what happens if you want to achieve the opposite? Instead of paying an increasing interest rate for increasing balances, banks may want to incent customers not to bring over balances from other institutions or shed balances above a certain amount, in hopes of improving overall profitability. Here, banks could structure a reverse-tiering system that pays a decreasing rate for higher balances. For example, an account might start off paying 40bp for balances up to $50k and then drop to 20bp on balances up to $250k and then 10bp for balances above $250k. Banks that still believe paying a higher rate is important can move that rate to the lowest tier and control costs by decreasing the balance cut-off. Further, by incenting both retail and small business customers to reinvest balances over a certain amount with other institutions, banks can save on both FDIC assessment and capital costs. A smile tier should also be considered by banks with higher balance deposit demographics. Here, a reverse tier is utilized up to the $250k insurance limit. At balances above $250k, interest rate, analysis charges or service is increased to incent customers to forgo insurance at higher balances. While the smile structure is interesting and might be appropriate for certain banks, we hesitate to employ such a structure, as it tends to underscore the break in FDIC insurance. However, such a structure might work most efficiently for a set of customers that keep high balances that you want to pull over from other institutions. There are a few structuring points to keep in mind when fine tuning tiers. First, before you set or change tiers, understand account balances. The simplest way to look at this is to chart average balance over a period of time, such as the average quarterly balance for the past 2Ys. Other more statistically and econometrically driven approaches tend to be more accurate, but not markedly so. In short, you really want to know how many accounts you have in each deposit balance bucket. Next, you want to exclude any accounts that exhibit high interest rate sensitivity or high cyclicality of cash flows, since tiering will be unlikely to change behavior. What is left is a breakdown that tells you the percentage of accounts in each deposit segment. Once known, banks should choose tiering buckets to accomplish goals. Hence, if a bank has a high number of accounts with $1mm balances and above, the $1mm level may be ripe to reduce rate. Keep in mind that when utilizing a reverse tier structure, you are managing the top or maximum tier, instead of the minimum, so tiers will naturally be higher. Further, when working with maximum tiers, account sensitivity is less, so don't expect the same level of customer behavioral change as you see with minimum tier levels. Going to a reverse or smile tier isn't for every bank, but it might be the solution for some to better manage deposit profitability. If you are looking to lower your net cost of funds and shrink your balance sheet in-line with earning assets, experiment with a reverse tier in an MMDA account to see how your customer base reacts. You might find it an easy way to boost profits.

BANK NEWS

Closed (90)

Regulators closed: 1) Polk County Bank ($92mm, IA) and sold it to Grinnell State Bank ($172mm, IA). Grinnell gets 3 branches, all of the deposits and essentially all of the deposits. 2) Central Progressive Bank ($383mm, LA) and sold it to First NBC Bank ($1.7B, LA). First NBC gets 17 branches, 92% of the assets and all deposits.

Agriculture Lending

The Fed KC reports cropland values jumped 25% in its district over the past year to a record high and ranchland values surged 14%. Meanwhile, Fed Chicago reports farmland values in its district soared to a record, up 25% in the 3Q as the value of agricultural land increased 7%.

No Pensions

SunTrust has announced it would no longer offer pension benefits to employees after 12/31 of this year, as it seeks to reduce employee benefits costs. The Bank said it will continue to offer 401(k) plans, increase its matching contribution from 5% to 6% and make discretionary contributions starting in 2013.