Rewards Checking And Other Miracles

by Steve Brown

It's hard to miss those blinking ads promoting miracle weight loss solutions in the margins of your most frequently visited websites. These ads promise quick and easy weight loss through pills, acai berries, green coffee extract, raspberry ketone and countless other products. The reason such ads attract people is because people want to believe there is a miracle quick-fix to their weight woes. The truth is there is no miracle cure. Old-fashioned healthy diet and exercise are the only likely paths to success. Ads for products that claim to deliver miraculous results fall into the category of "if it seems too good to be true, it probably is."

Bankers don't normally go after something resembling a miracle cure, instead, they prefer to follow a more conservative path. But they can be swayed. Even this group of level-headed individuals will consider programs that come into vogue, and seem to offer plausible solutions to intractable problems.

Rewards checking programs are an example. Rewards checking programs have a hard time in a rising interest rate environment because they are a deposit solution created for a falling rate environment. They are designed to assist banks who need to bring in deposits and the premise is that a really attractive interest rate on a checking account will draw in new customers. There is a catch though; receiving the rate is based on achieving a certain number of transactions per month. The success of the program, at least from the bank's point of view, depends upon most customers failing to reach the transaction thresholds so the bank doesn't pay the elevated interest rate very often. The rate paid is generally around the same as for a 5Y CD.

Typically 50% of customers that go into these types of programs are already customers of the bank, so the idea of bringing in new deposits often does not pan out. In addition, people are far more careful than expected about reaching the thresholds necessary to earn the high interest rate, so more do so than you might believe. In the end, deposits mostly don't grow and the cost of funds for the whole bank rises.

Our analysis finds that banks drawn to programs like this typically have higher cost of funds (COF) or they wouldn't be looking for a miracle cure. Meanwhile, banks considering such programs think they might be both positive and effortless. Unfortunately, the end-result is more akin to running a complicated CD special. Internal customers often become rate-sensitized, cheap deposits can be cannibalized, and the cost of funds rises.

Beyond these issues is the disturbance of such programs to the natural distribution of deposits that generally occurs in banks. The natural balance dictates that utility accounts with absolute liquidity--like checking accounts--have no restrictions on availability and also pay little or no interest. Savings accounts are slightly more restricted, and as such, will pay a slightly higher rate. Then finally come CDs, which have the highest paid rates because they carry the greatest restrictions. Consider the impact of a utility account like a checking account that carries higher operational expenses and raises the COF of the bank--it can be a double whammy.

For banks that have already gone down this path but want to extricate themselves, the going can be tricky. This is due to both provider contracts and sensitive customers. But there may still be a window of opportunity given deposit rates are quite low and most customers are not particularly sensitive to deposit rates just yet. PCBB's Liability Coach has helped numerous banks implement progressive steps to address their funding. Slow and steady effort has helped banks achieve success. There is no miracle cure, but over time, with effort and with expert advice a lower COF can usually be achieved.

BANK NEWS

Guarantees

A study by Pepperdine University found banks require collateral 100% of the time for loans of $1mm, but only 63% for loans of $100mm. Meanwhile, personal guarantees were nearly always required for loans less than $5mm.

Regulatory Focus

The OCC reports the top 5 categories where community banks are flagged for Matters Requiring Attention (MRA) are in credit administration (32%), compliance (12%), management (11%), information technology (9%) and audit (6%).

IRR concern

Regulatory communications indicate regulators are worried about interest rate risk because as rates increase bank securities holdings could see a sharp decline in value (that hits capital) and floating rate loans may exhibit deterioration in debt service coverage (leading to increased defaults).

Deposit Analysis

Regulators are concerned that deposits that flooded into the banking system may move back out once rates begin to rise. As such, they warn banks to focus on deposit pricing and runoff assumptions. Regulators say banks should model alternative deposit assumptions to test the impact to earnings, liquidity and economic capital from rising rates.

Risk Worries

The OCC identifies the following as key risk issues community banks should be closely monitoring: strategic risk as business models are changed, management succession planning, retention of key staff, underwriting erosion due to heavy competition, expanding into loan products that require specialized skills and processes, increasing IRR exposures, increased use of third parties to perform operational and business functions.

Acquisitions

The FDIC reports that over the past 10Ys, about 67% of the time a community bank is acquired, the acquiring bank is another community bank.