Ways to Respond to Rising Interest Rates

small business business customers

Summary: Financial institutions enjoyed client deposit surges through the end of last year, but extreme rate hikes from the Fed may change that. As CFIs feel pressure to raise their rates on deposits to keep customers, it's important to consider what other strategies CFIs can deploy to retain deposit levels and client relationships.

Imagine going 165K miles per hour. That's the peak speed NASA's Juno spacecraft reached on its five-year journey to Jupiter, before it settled into orbit around the massive planet in 2016. Although the Federal Reserve's rate hikes haven't come anywhere close to this speed, they're still being raised at the most aggressive pace since 1994. By now, many community financial institutions (CFIs) are feeling pressure from their commercial clients to pay more on deposits in order to retain their business. Should your financial institution raise the rates it pays?

For many CFIs, the instinctive answer is no. They have no need to compete on deposit rates, because they have abundant deposits. Commercial banks enjoyed a surge in client deposits in the first 18 months of the pandemic, growing 34% from March 2020 to the end of 2021. About 60% of that growth was due to the combination of government stimulus payments and businesses using credit lines to build precautionary liquidity. Like all economic circumstances, though, this trend is subject to change at any time.

Deposit levels can't stay high forever

No one can entirely predict where loan demand, capital investment, deposit levels, and economic growth are headed in the future. It's fairly certain, however, that financial institutions won't always have such abundant deposits. Eventually, CFIs will once again need to compete for deposits and consider the cost of capital. They'll need customers who will take out loans when loan demand returns.

Upward pressure on deposit pricing isn't yet widespread, but Peter Serene, the director of commercial banking at the consulting firm Curinos, warns that they're *"starting to see material outflows at some banks."*

Commercial deposit volumes are still a little higher than in 2021 overall, though a Curinos study showed that banks in the bottom quartile for commercial deposit growth endured a 10% decrease YoY. The same study showed that the average interest rates on commercial deposits went up 10 bps between April and May, though overall rates are still below their pre-COVID-19 levels. Rebates on non-interest-bearing commercial deposits have stayed level, though Curinos found that almost all liquidity managers think CFIs will ultimately pay higher rebates this year.

Because most banks have indicated that they are in no rush to raise the rates they pay on deposits, CFIs have some time to sort out a response to these changing conditions. This lets CFIs create a measured strategy to take full advantage of opportunities that arise in this current financial climate.

Upheaval means opportunity

At some point, financial institutions will raise rates on deposits. Challenger banks will likely be the first to offer more competitive interest rates, and other financial institutions will follow suit. Some customers will stay with their existing financial institutions, while others will shop around for better rates.
That search for better rates is an opportunity for CFIs, and not just a chance to outcompete other financial institutions on interest rates.

While raising rates is a good bet on maintaining your customer base, it's not a foolproof method — or even the only method — to increase the value of your institution for your customers. It also won't guarantee loyalty in the long term, if a competitor's rates are higher. You'll need to give customers deeper reasons to choose you over your competition.

Here are some **strategies aside from raising rates that could help CFIs retain customers** and draw in new ones who've decided to shop around:

- **Refreshing your pricing strategies.** As interest rates rise, some clients will favor capital market investments, which could mean lower deposit levels and potentially thinner profits. An understanding of client relationships can help you price products appropriately for your institution's needs.
- **Deepening wallet share.** Determine where you can retain deposits by deepening relationships with key customers and drive customer profitability. Understanding the value of each customer relationship enables CFIs to make targeted and compelling offers to new and existing customers. Customer profitability tools, such as Profitability FIT, allow you to do this. Also look to integrate cash management and back-office services, while fee offsets are high. These efforts can take the better part of a year to yield results, so consider beginning now.
- **Focusing on technology.** Offer innovative, digital experiences, including online account opening. Better experiences build trust, and trust builds loyalty.
- **Investing in your brand.** It's the bedrock of the trust that's between you and your clients, so make sure the message you're sending out fits what your CFI is all about. If your logo and color scheme look dated or your taglines don't reflect your current strategy and values, it's time to revamp.
- **Making your forecasting models more robust.** Your CFI needs a deposit estimation algorithm informed by account-level data on payment flows. Incorporate the activity of the Fed's balance sheet and projected tightening or easing. Client balances will go up and down over time, and models should recognize this. Because there is doubt about whether historical interest rates will be useful future tools, forecasts should be in wider bands and adjustable.

  While raising rates may become a trend soon, it's not the only thing that customers need right now. CFIs that take proactive steps to build customer loyalty and deepen existing relationships will have more success in retaining that business in this everchanging market, instead of simply relying on eventual deposit rate increases.

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ECONOMY & RATES

Rates As Of: 09/14/2022 05:43AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg

3M	3.28	0.32	3.22
6M	3.75	0.43	3.56
1Y	3.96	0.45	3.57
2Y	3.82	0.32	3.08
5Y	3.65	0.30	2.38
10Y	3.47	0.27	1.95
30Y	3.54	0.24	1.63

FF Market	**FF Disc**	**IORB**
2.33	2.50	2.40
SOFR	**Prime**	**OBFR**
2.28	5.50	2.32