The New Reality of an Up-Rate Environment

What Financial Institutions Need to Know

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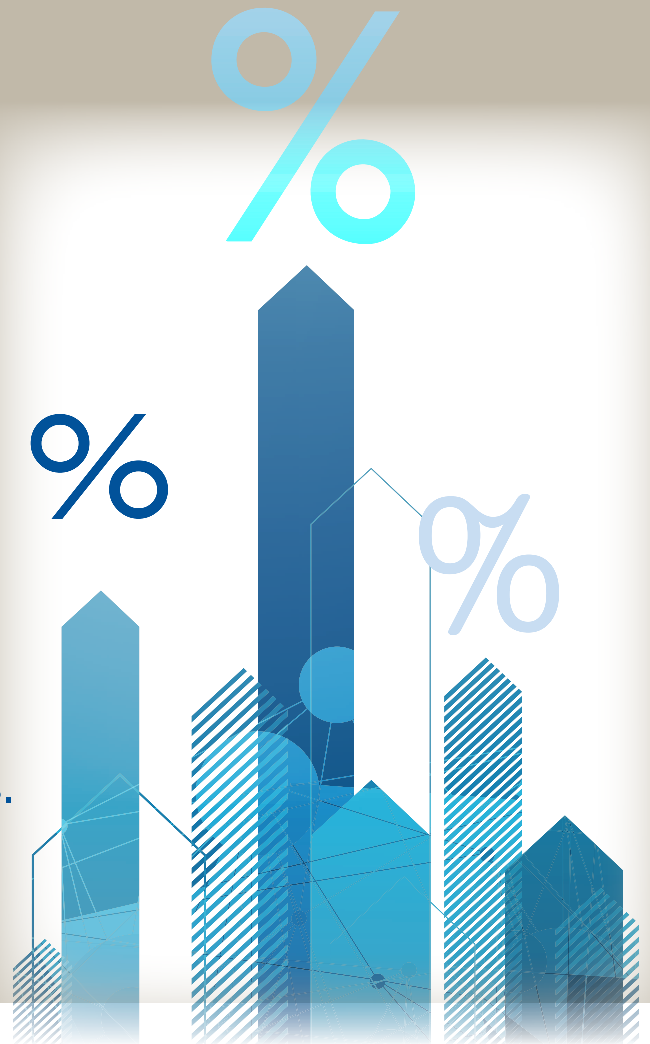
As we all know, banks and credit unions face substantial challenges. Credit risk management, regulatory and compliance demands, developing and retaining talent, and growing non-interest revenue are just a few.

But one thing financial institutions have not had to worry about for some time is the very thing that drives the whole business model.

Namely, interest rates.

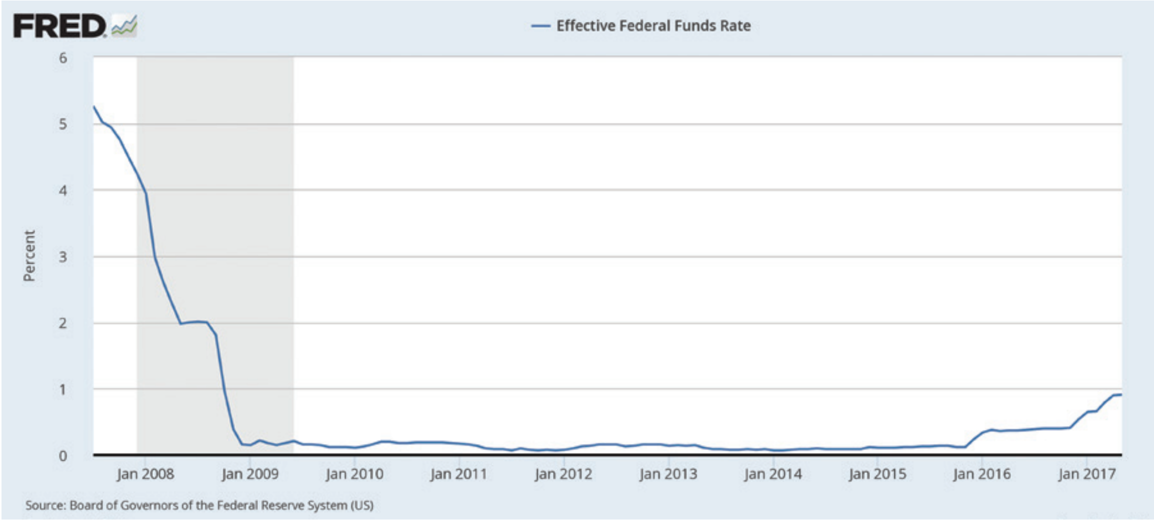


Historically Low Interest Rates

For quite a while now — nearly a decade, actually — the Federal Reserve had held interest rates at historically low levels. With a target rate of just 0.25 percent[1], the net interest margins (NIMs) of financial institutions have been compressed, putting a heavy strain on profitability.

[1] Isidore, Chris *"Fed slashes key rate to near zero,"* CNN Money, December 16, 2008

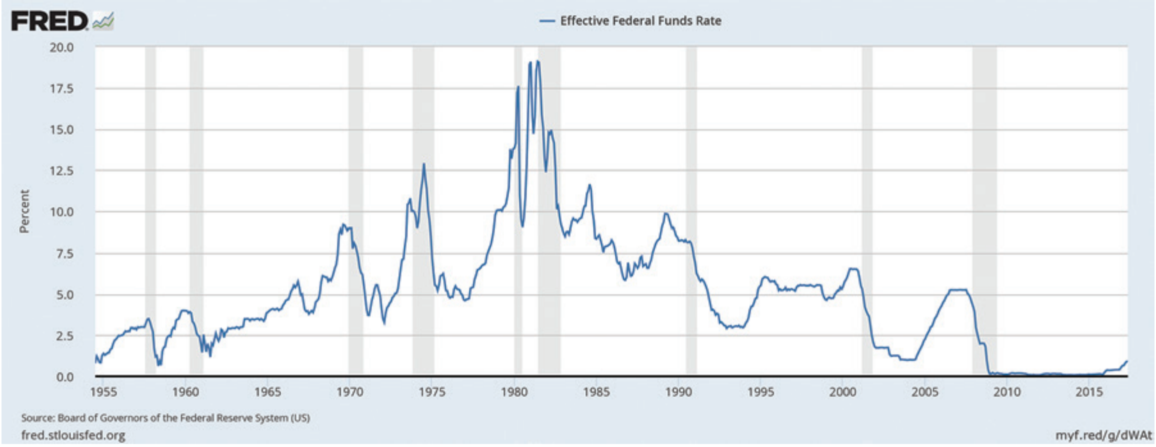
You can see in the graph on right that in July 2007 the target for Fed Funds was 5.25 percent. This means the prime rate for the best-qualified borrowers would have been around 8.25 percent.



Then, a month later, the Fed made its first of 14 moves in a 17-month span that stopped with the target rate settling in at 0.25 percent in December 2008[2]. Now, the prime rate for borrowers is just 3.25 percent. Just like that, 500 basis points of spread had been lost from non-interest bearing deposits.

Unprecedented Environment for Lenders

Just how unusual is this environment? Take a look at the chart on right, which shows the effective Fed Funds Rate dating back to 1955.



It's clear these last 10 years have no parallel in modern U.S. history. It is truly an unprecedented event.

Factor in that while interest rates remained artificially low during this span:

- Debit interchange rates were reduced by more than 70 percent for covered financial institutions under the Durbin Amendment
- Fee income was dramatically reduced by changes to Reg. E
- Costs of compliance with the Office of the Comptroller of the Currency (OCC), the Federal Reserve, and the newly formed Consumer Financial Protection Bureau (CFPB) skyrocketed

[2] Ibid.

What Can Bankers Do?

So, what is a banker to do? Where and how do they create value?

Well, one lever still available to them is pricing. A few basis points here and there on either side of the balance sheet can add up quickly. What is so unusual now is that we have not been in the initial stages of an up-rate environment since August 2004. That's nearly 13 years ago.

Consider the majority of product managers, treasurers and chief financial officers in the field today. Consider those in your own institution. How many of them are in the same role now as they were in 2004? Probably very few, if any.

Because financial institutions have not had to navigate this environment in so long, the learning from past experiences may be distant or nonexistent.

Think of it this way: Would you invest your life savings at the beginning of a bear market with a financial advisor who has never managed money in a bear market?

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Non-interest Bearing Deposits

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More good news comes in the pricing strategy for these accounts. There isn't one. They earn nothing, so lack of experience is not a factor.

Yet the challenge here is steep. We know full well the difficulties associated with the acquisition of net new checking households.

Outrun the Competition

There is some good news. It reminds me of the old adage about two men hiking in the woods who come upon a grizzly bear. The bear stands up, roars, and prepares to run the men down. Then, inexplicably, one of the two men reaches into his backpack, calmly pulls on his running shoes and laces them up. "What are you doing?" the other man shrieks at him. "You can't outrun a bear!" To which the now running-shoe-clad man replies, "I don't have to outrun the bear. I only have to outrun you."

The same holds true for financial institutions, maybe now more than ever. With everything that's been going on in the market — margin compression, negative fee income growth, higher regulatory costs and difficulties in attracting and retaining talent — now, finally, comes some relief in the form of higher interest rates, which will help expand NIMs and overall profitability.

To do this, banks and credit unions need a steady and growing supply of core non-interest bearing (NIB) demand deposit account (DDA) balances. The systematic process of earning and retaining these at a faster rate than your peers is the equivalent of outrunning your hiking partner, not outrunning the bear.

A Tale of Two Strategies

What if a bank or credit union's funding strategy has relied too heavily on time deposits and other higher and more rate-sensitive deposits? In this case, as loan rates rise, deposit rates will rise as well, almost in lockstep.

On the other hand, a bank or credit union that has a long-term commitment to acquiring net new checking-based households is now in a position to take advantage of the leverage the new rate environment affords.

To help illustrate, consider the example of two local community banks. Both have $500 million in earning assets, both have a loan-to-deposit ratio of 90 percent, and both have 75 percent of their loans floating so that they can take advantage of the rising rates.

Bank A's liability side of the balance sheet is 40 percent NIB, 30 percent low-cost IB deposits, and 30 percent rate-sensitive deposits. If its total blended cost of deposits is 1.00 percent, and its average yield on loans is 3.75 percent, then its NIM is 2.75 percent and annual NIM is $13.75 million.

Bank B's liability side is 15 percent NIB, 25 percent low-cost IB deposits, and 60 percent rate-sensitive deposits. In this scenario, assuming the same yield on loans, the bank's cost of funds will be on the order of 1.75 percent and annual NIM will be $10 million. That's a $3.75 million difference in profitability — or 37.5 percent. Imagine the same scenario for a bank with $5 billion in earning assets. Or $50 billion.

In practical terms, the above example means that in a common market where costs can be eliminated through reducing branches and common functions, Bank B just became an acquisition target. It is almost certainly unable to survive long term. It needs advice, programs and/or products to help it remix the liability side of its balance sheet.

Ultimately, banks and credit unions don't need to outrun the bear. They just need to acquire the types of account holders with low cost, durable deposits, at a quicker rate than their peers. With these, they will outpace the market in terms of revenue and profitability growth. Most importantly, they will live to take another hike in the woods.

BANKS A & B $500m earning assets | Loan-to-deposit ratio 90% | 75% floating loans

	Liability side	Low-cost IB deposits	Rate-sensitive deposits	Total blended deposits costs	Average loan yield	NIM	Annual NIM
BANK A	40%	30%	30%	1.00%	3.75%	2.75	$13.75 mil
BANK B	15%	25%	60%	1.75%	3.75%	2.00	$10 mil

$3.75 million difference in profitability

BANK B Acquisition target

With more than 20 years of banking experience, Mr. Claypoole's areas of expertise include credit policy, commercial finance, and product, segment and marketing management. He is known for his thought leadership and as an industry "idea generator," having received BAI's 2010 Maverick Banker of the Year Award for his innovative efforts in product development.

To learn more about Harland Clarke visit HarlandClarke.com.