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Non-maturity deposits

Examiners scrutinizing management of high-growth deposits

Examiners are insisting that institutions more effectively address continuing uncertainties related to management of excess, non-maturity deposits that have accumulated during the past few years, a recent industry report warns.

The concern is that when the next economic cycle of rising interest rates occurs, many non-maturity deposits may either leave the institution or shift back into CDs.

The report by Darling Consulting Group, "Uncovering Strategic Opportunities in Your Deposit Base," points out that there is a "rapidly accelerating exam trend where regulators are taking deep dives into liquidity, IRR and capital management processes, with a very particular emphasis on deposit-related assumptions and assumption support."

Predictability challenge

The report explains that all non-maturity deposits possess an inherent problem of predictability—when a customer makes a deposit, nobody knows for certain how long those funds will remain in an account. Obviously, it's difficult to predict how customers will react to change, such as rates paid on the account, changes in the bond or equity markets, or even changes in the economy.

Nonetheless, institutions must make a number of assumptions every day about the likely behaviors of their deposit base, which impact not only deposit pricing behavior and decisions on product development, but also the parameters assigned to risk models addressing interest rate risk, liquidity risk and capital planning, it says.

And these assumptions are significantly affected by the relative size of the institution's non-maturity base and the extent to which deposit growth has exceeded typical growth over the past five years.

The report explains that since the financial crisis began in 2008, non-maturity deposits have grown industry-wide at an annualized growth rate of 9%, greatly exceeding the corresponding growth rate of 1% that took place from 2004 to 2008. It adds: "this outsized growth combined with continued above-average inflows, even at today's near-zero rates, begs an obvious question--are current non-maturity deposit levels sustainable?"

Rate environment

It also warns that the longer the current low-rate, slow-growth economic environment drags on, the greater the chance for the build-up of temporary or rate-sensitive deposits that will produce elevated interest rate risk and liquidity-depleting pressures in the next economic growth cycle.

"The stark reality is that all depository institutions have non-maturity deposits that will either leave or shift back into CDs when this occurs," the report says. "While few institutions would disagree, most have not taken the appropriate actions to get their arms more firmly around this bubbling issue."

Given such an environment, it's not surprising that examiners have ratcheted up their scrutiny of institutions to ensure that they substantiate and defend the reasonableness of their institution-specific, deposit behavior assumptions, including sensitivity testing and the evaluation of stress-testing assumptions used for both liquidity and interest rate risk modeling.

The enhanced focus on deposit assumptions was first signaled in the 2010 joint agency advisories on interest rate risk and liquidity risk management, and was later underscored in the agencies' 2012 "frequently asked questions" on IRR management, the report says.

Thus, it's imperative for institutions to more effectively document, monitor, and update their assumptions for deposit price

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sensitivity (betas), decay rates and the potential for deposit balance volatility on a regular basis. "To be sure, pricing betas and decay rates can be the single biggest drivers of risk-model outcomes," the report says.

Banks and credit unions absolutely must demonstrate that they have effectively managed the inherent uncertainties, and one way to do this is by conducting an institution-wide deposit study, the report advises.

"For most institutions, support for deposit assumptions is based upon little more than documented gut feelings, estimates based upon some form of industry average, or some perceived safe harbor," the report says.

In some cases, institutions just assume a "worst-case scenario" for their baseline set of assumptions, guaranteeing that their risk analyses provide little value in helping management and the board understand their risk position.

On the other hand, some institutions employ a more formal approach by formulating deposit beta assumptions, by looking back at historical rates paid on accounts, and by examining how they have changed relative to a market index over a specific time period.

While a better approach than simply the "gut feeling" or "worst case scenario," such an approach still carries a risk of lacking meaningful statistical support, or not adjusting for data "noise" that can be prevalent in the data being examined, the report warns.

Outsourced studies

Still other institutions, interested in a more data-driven solution, often look to third-party vendors to provide them with "core deposit studies," or some similarly-named deposit analyses. These studies are rooted in mathematical theory, and seek to analyze historical financial institution data in such a way as to assign statistical support to an institution's deposit assumptions, it says.

In theory, this approach appears to be what the IRR advisory meant when it called for institutions to document and support their deposit assumptions. But one of the challenges for institutions that outsource their analysis is that such studies can all too often "read like a statistics thesis paper." As a result, many institutions find the results of these studies difficult to digest and understand, thereby limiting their utility.

For example, such a study may be filled with numerous charts, graphs, equations, regression lines and numerical tables carried out to four decimal places — collectively implying a level of predictability or precision that simply does not exist. "In the end, when the institution is left to turn these results into reasonable assumptions, the information can be lost in translation," the report says.

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Report on deposit issues
Darling Consulting Group
Newburyport, Mass.

Examiner reactions

In such situations, examiners are likely to question the study's credibility. It's thus essential for deposit studies to "help bring to life" a picture of the institution's deposit base. "It should be more than just a report that sits in a drawer or is handed to a regulator," the report stresses.

An effective study should be informative and educational, and should provide a clear overview of the key information that senior management needs.

In essence, then, institutions basically have three choices: wait for regulators to mandate the need for sufficient deposit assumption documentation; get ahead of the issue and perform some minimum-level study in hopes of avoiding regulatory criticism; or conduct a deposit study that goes beyond compliance minimums and provides ongoing strategic benefits.

The report advises that the third option makes the most sense, but institutions that carry one out must ensure that the results not only offer insights on overall deposit strategy development, but also improve management's understanding of IRR, while enhancing liquidity forecasts, stress testing activities and capital planning.

Whatever an institution decides to do, their actions must be based on the mandates given in the 2012 regulatory advisory on interest rate risk management, which says they must use assumptions that "reflect the institution's profile and activities and generally avoid reliance on industry estimates or default vendor assumptions," the report says.

You may review other perspectives on IRR management in the Industry Insights archive on the FMS web site at www.fmsinc.org. FMU