Deposit Pricing Analysis in Advance of Rising Rates

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It seems that regardless of the given positive economic indicator reported, one can find an offsetting indicator pointed in the complete opposite direction. The unemployment rate has been improving, yet there has been minimal wage growth (much less wage pressure). The Fed reiterated there is substantial slack in the employment picture in its most recent testimony. Asset purchases by the Federal Reserve are winding down, while China is buying more than ever before. Positive growth in the U.S. (this quarter that is) is countered by trouble in Europe. The ECB and China have recently lowered rates, while the overall consensus here seems to be that the Fed will change course and begin to tighten monetary policy in the middle of 2015.

ALCO strategies should never be employed assuming a specific rate forecast. How would that have worked out over the last five years, when many people “knew” rates were going to rise? Answer honestly!

Nevertheless, the remainder of this article will assume the market consensus is correct and that short-term rates will be increasing in 2015. As such, credit unions are only three to four quarters away from feeling pressure on their funding costs. I have already seen (and honestly suggested to some clients) deposit specials in the 1.00-1.25% range on both non-maturity and short time deposits.

Before raising the rates on your existing accounts and/or introducing a new special, much work needs to be done. First, how much of your deposit base is truly rate sensitive? Answering this question can be done by gut, by core deposit study, and anything in between. But the question must be answered. What other questions should you ask?

- For your liquidity and interest rate risk models, how often are the assumptions updated and when was the last time they were validated by a study?
- How much growth have you seen in deposits in the last five years?
- Is the growth abnormal (i.e., surge)?
- Has there been a shift from CDs to non-maturity deposits?
- Have average balances increased? If so, in which accounts? Are they retail or business?
- Have you increased the number of deposit accounts?
- Have you stress-tested your liquidity and interest rate risk models?
- Can you afford to lose deposits, in terms of liquidity, interest rate risk, and earnings?

Once the rate-sensitive customers are identified, a multitude of deposit pricing strategies can be employed. One very simple tool we at Darling Consulting Group have used through many different rate cycles to help identify the best strategy is the marginal cost of funds (MCOF) analysis.

This analysis can be used to analyze the risk reward of deposit pricing increases (or decreases) as well as to determine the break-even point at which it either does or does not make sense to change deposit rates.

Marginal Cost of Funds Analysis
MMDA

BALANCE: $25,000,000

CURRENT RATE: 0.25%

		RATE INCREASE	
		0.25%	0.50%
RUNOFF PROTECTED	10.00%	2.75%	5.25%
	20.00%	1.50%	2.75%
	30.00%	1.08%	1.92%

In the simple example above, a credit union is considering increasing its money market account rate 50 basis points to satisfy the contingent of “squeaky wheel” customers. Suppose that this segment of customers makes up 20% of the deposit base (which in this example is $5 million). Using the MCOF analysis, the breakeven rate at which the credit union could replace the $5 million is 2.75%, assuming the money leaves without an increase in the existing rate, is 2.75%. In other words, the credit union could replace $5 million with other funds costing as much as 2.75% (through borrowing or other sources) without increasing current interest expense.

Another strategy may be to introduce a new premium deposit product to attract new dollars and to identify existing customers who are rate-sensitive. This strategy would allow you to offer a competitive product, and only pay those looking for a higher rate.

Either way, interest expense will increase. How will you pay for that increase?

One way will likely be to grow your balance sheet. Again, a simple marginal cost of funds break-even analysis can help determine how much growth will be necessary to offset the increase in interest expense.

For example, a promotional product is introduced at 1.00% and 20% of the credit union’s existing $50 million money market balance accounts (currently paying 0.25%) shift to the new product. To cover the additional interest expense associated with the shift, a marginal cost of funds analysis would show that the balance sheet would need to grow at $2.5 million at a spread of 3.00% to cover the additional cost of the shift.

These simple analyses can and should be used as part of your strategic planning process to help determine if a particular deposit strategy makes financial sense. Assuming we are three to four quarters from a rising rate environment, your competitors are having conversations about deposit growth/pricing strategies.

Some of you should use these and other tools to help play defense against your competitors’ deposit pricing strategy, while others should perform analysis to help you play offense and steal your competitors’ deposits.

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Either way, you should be formulating strategies today to ensure the best possible outcome for your balance sheet.

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