Batten Down the Hatches

Trying to out-run the storm in the credit markets, many banks are setting full sail towards the historically safe harbor of retail deposits. In need of stable funding and low-risk earnings, banks have accelerated the fight for increased share of consumer and small business deposits, which many have come to realize are the foundation of US bank profits. With market conditions changing rapidly, however, deposits may not offer the same level of profits that they historically have. Indeed, evidence indicates that the deposit markets might be poised for disruption that could have even larger and longer-term adverse profit implications for US banks than those of the current credit crisis.
Though external reporting on deposits is limited, the business generates half or more of the profits at many regional US banks, and the return on equity is often two to three times higher than that of lending businesses. While fees have increased steadily in recent years, most deposit revenue comes from net interest margin (NIM) – the difference between the amount of interest the bank pays to customers and the amount it can make in a “match-invested” portfolio of fixed-income assets (i.e. a low-credit-risk asset portfolio with similar duration and convexity to the deposit liabilities).

In addition to being high return, deposit gathering is typically a very low-risk business. However, the otherwise stable profits are highly dependent on prevailing market interest rates. In lower-rate environments, banks reduce the rate of interest they pay to their customers, but the entire decline typically cannot be passed on. As a result, the bank’s interest income is reduced more than its interest expense, and the revenue margin compresses. The phenomenon of spread compression when rates fall is observed most readily in checkable deposits, which often pay near-zero interest regardless of prevailing rates; yet it also occurs with savings products.

Between the end of 2007 and the beginning of 2008, prevailing market interest rates fell dramatically, with three-month LIBOR dropping nearly 2.5% – from more than 5.7% in September to 3.3% at the end of January. A level of 3.3% is well below the long-term average of about 4.6%, but is still well above the recent nadir of 1.1% reached in 2003. So, why is there cause for concern? The difference today is the aggressiveness with which many players are using price as a lever to drive deposit balance growth. When rates fall, deposit margins inevitably will contract. Yet, the current pricing in the market has many institutions posting rates that are at negative margin to LIBOR. In other words, unless there are atypical conditions at play, each dollar of deposit balance that the bank books will reduce its earnings.¹

¹ Most banks set their internal “transfer price” based on the LIBOR curve and the expected duration of the deposits. We use three-month LIBOR as an example in this note, but the correct index ranges from overnight to 10 years depending on the specific characteristics of the deposits in question.
Figure 1: Falling LIBOR and current deposit rates – a negative margin environment

Current spreads on “best available rate” products are negative at most banks.

How did we get here?

While the absolute level of LIBOR is not far below historical levels, the speed of the recent fall in rates has been extreme. Many institutions have simply not been able to keep up with the speed of the decline. For these banks, we would expect pricing margins to improve somewhat in the coming weeks. Given the continued uncertainty in the markets and the Federal Reserve’s demonstrated willingness to make significant rate cuts, all banks likely should revisit their current pricing routines and increase the frequency of their reviews to be better prepared for further cuts (as well as eventual rises).

If the prevailing cause of the current market pricing indeed is simply the speed of the decline, then banks may need to lower their savings deposit margin expectations for 2008. However, particularly if they had hedge positions in place to protect against this scenario, the overall outlook for the year is guarded but not critical.

Source: Oliver Wyman analysis, Bloomberg data, bank websites
Best offered rate includes short-term CDs and liquid savings products and indicates the best available rate offered online at each institution on January 27th.
On the other hand, several factors indicate that the current pricing is not just the result of lagging response to falling rates, but instead could be much longer lasting. We see three particular factors that could be setting up 2008 as a highly challenging and potentially very dangerous year for the deposit business:

1. An intensifying skew in the value of deposits to different types of banks
2. High expectations for deposits to drive organic growth
3. A significant disparity in the sophistication of deposit management across institutions

1. **An intensifying skew in the value of deposits to different types of banks**

With the secondary markets for mortgages still very tight and the future of many mortgage-focused institutions still uncertain, the value of deposits to mortgage lenders has deviated sharply from that of multi-line commercial and regional banks. In effect, many mortgage lenders must have deposit businesses to support their core origination businesses – in some cases, apart from government sponsored enterprise (GSE)-conforming mortgages, these lenders can only originate loans that they themselves can fund and hold. Moreover, the very viability of these institutions as stand-alone businesses is being questioned, and their ability to raise deposits will be a key factor in determining the answer. The result is that mortgage lenders will “rationally” price deposits to a much higher rate than a typical commercial or regional bank. In effect, given their business model and current position, the deposits are simply worth more to them (and more than LIBOR).

On the other side, the “carry-trade” or gapping activity that banks used to help generate net interest margin in the past is both less available and less attractive than it once was. (This is the balance sheet management practice of generating earnings by investing short-term liabilities in long-term assets and creating NIM from the “gap” between the two). While some steepness has returned to the treasury curve, there is still less than half the gap that existed in 2003 when three-month LIBOR fell to 1.1%.

While the carry trade has less potential to generate earnings than it has in the past, many banks might not choose to pursue a carry strategy even if they could. Before the credit crisis of 2007 grabbed headlines, the gap crisis of 2005 and 2006 was at the fore of most bankers’ minds. In 2005 and 2006, the gap business that had once been seen as almost zero risk returned significant losses for the first
time in 20 years – pushing several banks into otherwise unforeseen mergers. With that memory fresh in the minds of bank treasurers, we would expect most institutions to be less aggressive with their positions – the net effect is that, even though LIBOR is still far from its historical low, the total revenue margin available from the combined deposit and carry businesses is probably nearing the low 0.03 level.\(^2\)

Overall then, the value of deposits is likely to be higher in 2008 for mortgage lenders than it has ever been (as their alternative sources of funding are limited and often priced well above LIBOR). At the same time, the value of deposits could touch historical low points for relatively deposit-rich regional and commercial banks. This disparity in deposit value presents a clear challenge to any traditional player hoping to grow total deposit share profitably.

2. High expectations for deposits to drive organic growth

Since the last economic downturn in 2001, banks have displayed renewed interest in the high returns and relatively stable earnings of deposits. With the opportunity for growth in lending highly restricted for 2008, many traditional banks again were looking to accelerate growth in deposits. Disappointed with their inability to accelerate the relatively slow growth that often comes with de novo branch builds or to energize core checking growth, many of these traditional banks have already shown a willingness to begin competing for share using rate and product design. Interest in rate-driven strategies is further abetted by the rapid growth in balances seen at institutions like ING and Countrywide.

In this regard, the timing of the fall in LIBOR has been particularly cruel. Occurring over the course of the fourth quarter, it happened after most institutions already had largely locked in their 2008 strategies. The planned growth to both balances and earnings that may have been possible – if aggressive – at the prevailing interest rates in September 2007, is now unlikely. This has left many facing an immediate challenge at the start of the year, and a difficult choice between reaching balance goals to which managers have committed and maximizing margins and profits.

Many institutions are feeling the need to show some kind of positive organic growth after several challenging years. Most likely, a few will choose to pursue balances and reportable signs of improvement (such

\(^2\) We typically separate the “deposit” and “carry” businesses in our discussions of bank profitability, as they are fundamentally separate pursuits that do not depend on each other. We have grouped them here since many banks link them in their business practices.
as deposit share or “same-store growth”) rather than deposit earnings, which are much harder to see (as very few institutions publicly report deposit profits). In fact, since prevailing rates are falling, the reported deposit “cost of funds” indeed will fall, even for institutions that are significantly reducing the margin on their deposit books.

The overall negative impact to bank earnings though will be much harder to hide – particularly if the pricing of mortgage lenders remains as aggressive as it currently is. In 2006, the average net interest margin on deposits for the top-50 deposit takers was greater than 2.5% – with some convenience or service-led banks realizing margins over 3.5%. It will not take long to erode those returns if top-of-market pricing requires being 50 to 100 basis points in the red. And if that pricing affects existing balances as well as new growth, the impact could quickly become very alarming (while advertised prices are currently often below water, the vast majority of “core” deposit balances are on bank balance sheets at comfortably higher spreads).

**Figure 2: Deposit revenue spreads for the top-50 US banks**

All deposits are not the same – superior mix and lower rates made those of the highest margin banks four times as profitable as those of online gatherers.

Average 2006 deposit NIM bucketed by NIM rank

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<tr>
<th>NIM Rank</th>
<th>Average 2006 NIM</th>
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<tr>
<td>Top 10</td>
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<tr>
<td>11-30</td>
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<tr>
<td>31-48</td>
<td>2.23%</td>
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In current conditions, some commercial banks’ “best offers” have a spread 400 bps below their existing book and 40 bps below water.

Online and mortgage players are priced 140 bps below water – but only 230 bps below their book.

Source: Oliver Wyman analysis

1. By deposit margin
2. By total deposit balances
3. A significant disparity in the sophistication of deposit management across institutions

The sophistication in the management of deposits as a profit-generating business (rather than, for example, as a funding source) varies dramatically across US banks. Some have developed advanced approaches integrating expertise from treasury, marketing, customer science and channel delivery which are appropriate for a business line that, by some accounts, generates more than half of the profit and three-fourths of the above hurdle returns at typical regional banks. Yet, many banks continue to operate the business with a much lower level of management depth than is appropriate for such an important source of profits. This trend has been turning slowly – but if the conditions discussed above hold, 2008 could be a year in which the differences in sophistication deliver dramatic differences in results.

In fact, there is as much opportunity to do harm as there is to do good through “innovation” in deposit pricing. A careful review of some of the more aggressive tactics deployed over the past few years indicates a very high rate of failure, with severely negative consequences. The basic challenge is that deposits are so profitable in part because of customers’ willingness to be “lazy” with large amounts of their savings, and these “sleeping” deposits are responsible for much of the net interest income in the banking sector. High-rate products designed to motivate the customers of other banks run a very high risk of instead rousing existing (highly profitable) customers of the aggressor bank.

Any effort to steal share or compete for new deposits on rate therefore risks off-setting any gains from new money with losses from cannibalization of existing balances (i.e. customers “awakened” by the new offers moving balances from their old low-rate, high-margin accounts to new high-rate, low-margin accounts). The difficulty in competing on price is that the profit margin on any dollar of balances brought in through rate tends to be much lower than the profit margin on any dollar of existing core deposits. Thus, a cannibalization rate as low as just 20% or 30% may produce a negative impact on near-term earnings, even if overall balances rise. Indeed, many of the high-rate products of the past few years, which may have appeared successful from the outside-in, were ultimately deemed failures at the institutions that launched them. In an environment where new offers are being priced below water (see Figure 2 above), the math clearly becomes even more challenging.
Most banks simply do not have the sophisticated pricing and targeting models, let alone the channel discipline or product structuring capability, necessary to participate successfully in price-led deposit competition – even in favorable market conditions. The required models incorporate customer elasticity, cannibalization risk, margin evolution over time and lifetime value. Instead, the prevailing automated models in the market generally take competitor pricing as the key input – without regard to differences in all of the other factors mentioned above.

Beyond the pricing model, few banks have the structures in place to deliver high-rate offers to new customers and balances while also protecting the margins on their existing books. Pricing strategies and tactics that could deliver positive results, if all of the constituencies were properly aligned, have the potential to be horribly misdirected as they filter through the organization. Typical examples of where it goes wrong include:

- High-rate products intended for new or at-risk customers are enthusiastically sold mostly to perfectly content, existing customers by branch employees trying to do the “right thing” for their customers as well as for themselves (incentive pay)
- High-rate products intended as teasers to bring in core deposit balances fail to bring core deposits (e.g. high-yield CD or money market promotions attached to opening a checking account – but the hoped-for checking balances never materialize)
- Predictive attrition models that lack power and have high rates of false positives

**Charting a course forward**

Without the sophistication required in deposit management, most traditional commercial banks likely would be far better off tuning their pricing strategy towards maximizing margins for 2008 and letting balance growth fall where it may. Adjusting deposit growth goals downward is not likely to be the first choice of senior business executives where they have made public declarations of planned share expansion. But given the direction the market has taken, it might be a much wiser and prudent course than competing on rate and risking significant cannibalization.

On the other hand, banks that do have the sophistication to compete in these challenging conditions could reap significant long-term rewards by running full steam ahead. Of course, this is not confined to price-led competition. Focusing on retention tactics, network management and incentives, alternative product design
and differentiated value propositions aimed at the highest value customers could replace some of the balance growth that had been targeted through rate. Although these strategies are more difficult to execute than dialing up the interest rate, they will deliver much more profitable growth.

To succeed in 2008, we believe that banks should immediately revisit their growth plans, with a careful eye towards six key considerations. In addition, they should take a sober inventory of their capabilities with regard to rate competition. We outline below our view of the critical issues to be considered in each of these two reviews.

**Review of 2008 growth plans**

1. **Review of the baseline** – How much of your existing deposit base is “core” vs. rate sensitive? How much is likely to run off if you cannot or choose not to match market-leading prices? (For most traditional commercial banks, the vast majority of deposit value sits in checking and low-rate savings accounts that are highly inelastic to price)

2. **Segmentation of balance growth goals** – How much were you expecting from new vs. existing customers? How much from checking, savings and time? What is the prevailing target – balances, margin, earnings or lifetime value?

3. **Treasury position** – What are your liquidity needs now and in the future? What is your cost of borrowing? What is the impact of your hedge positions? How does this impact your “real” funds transfer pricing (FTP)?

4. **Near vs. long-term perspective** – Do you have an opportunity to strive for a three-year profit-maximizing strategy, or must your view be 2008 (or even quarterly within 2008)?

5. **Market review** – How competitive is the local market, or each of the several local markets, in which you are present? What is your incumbent share in each of these markets, and what does that mean for where you can attack, where you must defend and where you should abstain?

6. **Stress testing** – Do you have a clear view of all the assumptions in your initiative business cases and the impact if they are incorrect? Particularly, what is the risk of cannibalization, and what is the impact to margins given current and potential LIBOR?
Checklist for rate competition capabilities

- **Core protection** – Are the capabilities that you intend to deploy well tested for the protection of core balances? How certain are you of the likely cannibalization rates vs. new balances and the business cases that underpin your strategy?

- **Product structure** – Are your existing product pricing, new product pricing and design optimized to maximize margins? How do your pricing and structure compare to competition by geography and balance tier? Is your pricing process dynamic enough to respond quickly to rapid changes in either prevailing or competitor rates? Do your pricing models support advanced strategies (e.g. do they include price elasticity, a life-time view of the economics of the balances, potential cannibalization and near-term/long-term margin)?

- **Targeting** – Do you have well-established retention models that can identify at-risk customers and balances? Do you know the “false positive” rate of these models? Is their deployment well governed (e.g. a process similar to that used for credit-decisioning models)?

- **Channel capability** – Are your branch network and other channels well positioned to deliver new offers to new customers/balances without disrupting “sleepy” customers? Will the branch staff sell a new high-rate product to every customer who walks in the front door, or will they use it only for new customers? Are your telephone and online channels able to deliver targeted offers to specific customers?

- **Treasury linkage** – Is the treasury function well connected to the deposit business? Is the “real FTP” effectively communicated to the business? Do the groups work as partners in developing the appropriate strategy?
Conclusion

Many banks have been slowly building their deposit capabilities over the past few years, but the fact remains that this business, which is at least as analytically complex as the credit card business, is still largely viewed and resourced as a “source of funding.” In fact, the analytical resource per dollar of value for deposits is usually 25% or less than that for credit cards. In the past, favorable market, regulatory and technological conditions combined with relatively benign competition and conservative growth goals made this resourcing passable if not indeed rational. Those days are over, or will be ending soon.

In the competitive market conditions of 2008, the status quo simply is not a viable option. Commercial and regional banks that ingenuously deploy aggressive pricing to pursue strategic growth ambitions will reduce near-term revenue and destroy long-term value – in many cases, this value will never be recovered. Given the overall banking prospects in 2008, bringing a “reduce the target” message to senior executives or to external constituencies is not an attractive strategy. However, just as reaching for aggressive growth led to irrational product structuring in mortgages, it can do so as well in deposits – and the potential adverse results in the medium term will be no less severe.

There is, of course, an opportunity to build sophistication quickly – particularly relative to the market average – and take advantage of this situation. Doing so will not be easy, particularly given the timeframe. Pursuing this strategy will require building a fully dedicated, cross-bank team of leading practitioners from treasury, product management, customer analytics and channel management (i.e. branches, call centers and the Internet). This is a complex task, particularly in the “matrix”-dominated world that governs many large institutions. However, for those banks that do not soon rise to the challenge, a difficult 2008 likely will be only the first of many more tough years ahead.
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