



The Competition for Deposits Will Pressure Community Banks

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It has long been recognized that core deposits represent one of the most valuable products offered by banks. The transaction account held by an individual or small business often represents the primary relationship that ties a customer to a bank and leads to the sale of other banking products. Deposit balances are relatively stable as customers do not generally move accounts for small differences or changes in interest rates and the balances are low cost due to FDIC insurance. Historically, banks have been able to invest these funds in relatively low risk assets and still earn an attractive spread. But, not for much longer.

Events Affecting Funding Costs

The credit crisis is dramatically changing the competitive landscape for bank deposit gathering. Three events, in particular, directly affect funding costs. The first is the increase in FDIC deposit insurance from \$100,000 to \$250,000 per depositor per institution. The second is the FDIC's Temporary Liquidity Guarantee Program (TLGP) of which one component provides full insurance coverage for non-interest bearing transaction accounts while another guarantees new issues of senior unsecured debt. The third is the Federal Reserve's apparent willingness to approve nonbank financial firms' applications to become bank holding companies.

Currently, bank deposits are automatically covered up to \$250,000. To compensate for this increased coverage and problems with failed institutions, premiums for insurance will rise accordingly. Banks have similarly been automatically included in the TLGP at no immediate cost and have until December 5, 2008 to opt out. The program will clearly benefit the largest institutions where greater numbers of business customers keep large balances in non-interest bearing transactions accounts. It will similarly benefit non-traditional banks. For example, on November 12th, GE announced that the FDIC would guarantee up to \$139 billion in debt issued by its GE Capital subsidiary under the TLGP.¹ The impact will be to lower GE's overall cost of borrowing and allow GE Capital to make loans at lower rates. Goldman Sachs, in turn, has already issued \$3 billion in debt under the TLGP that is now backed by the "full faith and credit of the United States."

¹ GE Capital owns a federal savings bank and an industrial loan company, both of which are eligible to participate in the TLGP.

More significant, however, is the Federal Reserve's accelerated approvals for firms to become bank holding companies. Consider the following applications and approvals during the past few months²:

- September 23: Goldman Sachs and Morgan Stanley convert to bank holding companies
- September 26: Raymond James applies to become a bank holding company
- October 30: General Motors Acceptance Corp. (GMAC) applies to become a bank holding company
- November 11: American Express converts to a bank holding company
- November 13: CIT Group applies to become a bank holding company
- November 17: Four insurance companies, Genworth Financial, Hartford Financial, Aegon, and Lincoln National requested permission to buy different independent thrifts

Why does everyone want to be a bank holding company? Why do the insurance companies want to buy small thrift institutions? At the time of its announcement, American Express had almost \$130 billion in assets but only \$7 billion in retail deposits. Kenneth Chenault, CEO, revealed the firm's strategy noting "We will continue to build a larger deposit base to broaden our funding sources ... With Federal Reserve oversight we should gain greater access to the capital on offer under the current and any future government-sponsored programs." American Express now has access to the discount window, issues commercial paper via the Treasury's commercial paper funding facility, qualifies for a preferred stock injection under the TARP Capital Purchase Program, and can issue FDIC-insured debt under TLGP. The Office of Thrift Supervision, in turn, assisted the four insurance companies in identifying problem thrifts and facilitating their conversion to thrift holding companies. Interestingly, the day that the insurers announced the acquisitions was the last day in which financial firms could qualify for TARP funding. Ramani Ayer, CEO of Hartford Financial, stated that "Securing capital at the terms available through the Capital Purchase Program could be a prudent course in this market environment. In short, American Express and the other non-bank financial firms want the funding stability of a bank.

Notice also how the largest banks and their recently acquired counterparts are paying relatively high deposit rates. Citigroup, Bank of America, Countrywide FSB, Wachovia and others recognize the value of their deposit franchises and have determined to maximize funding from this cheap source. I believe that when the largest banks exceed the legal maximum on allowable deposit market share, the maximums will be raised or will disappear.

Impact on Deposit Rates and Spreads

Banks are already engaged in heated competition for deposits, and it's going to get worse. Many of the largest institutions have been offering high rates on deposits to grow core

² Goldman Sachs, Morgan Stanley, GMAC, American Express and CIT Group all own industrial loan companies.

funding as they've depleted capital and purchased liquidity has dried up. As the economy slows and asset quality problems spread from the biggest institutions to community banks, profitability will decline and the rate of capital growth will slow. Regulatory pressures and sound business practices are leading many banks to try and grow core deposits and reduce their reliance on brokered deposits and other borrowed funds. Add to this the new bank holding companies and their eagerness for core deposit funding, and you have a recipe for continued turmoil in the deposit market. Given their other problems, many of the largest financial firms find that paying rates of 4% or more on CDs represents relatively cheap, and importantly stable, funding versus alternatives.

Consider the relationship between the prime rate and average 6-month CD rate presented in the chart.³ From 2005 – 2007 the difference ranged from 2.4% to 2.97% regardless of whether rates were rising or falling as they did during the last quarter of 2007. During the first three months of 2008, the difference averaged 3.08% but has fallen sharply since March. The spread's decline has resulted from CD rates not following the reductions in prime. In fact, since August 2008 the prime rate has fallen from 5% to 4%, yet the CD rate actually increased.

Why is this important? While many community banks have been able to lower their deposit rates recently as customers have fled to the safety of insured deposits, this is likely a temporary phenomenon. They have not yet seen or felt the full pressures from large financial institutions bidding deposit rates higher within their markets. Community banks operating in metropolitan areas have seen other banks, often large banks receiving TARP funding, pay up for deposits thereby raising all banks' funding costs. What happens when more financial institutions convert to bank holding companies and start expanding their banking operations by competing for deposits? What happens to the insurance fund when the FDIC guarantees more and more nonbank firms' debt? Deposit premiums are likely to increase for some time as the FDIC moves to restore full funding to its insurance fund.

Rising funding costs, in turn, put increased pressure on bank spreads. Unless an institution has the capability to raise loan rates or find additional fee income, loan yields will not keep pace with funding costs such that lower net interest margins are likely the norm.

Possible Strategies

Community banks who anticipate growing their balance sheets over the next few years should conduct a careful review of their deposit mix and funding alternatives. The following strategies are defensive in nature.

- **Enhance depositor relationships:** In anticipation of increased competition, it makes sense to shore up relationships with key depositors by continually touching

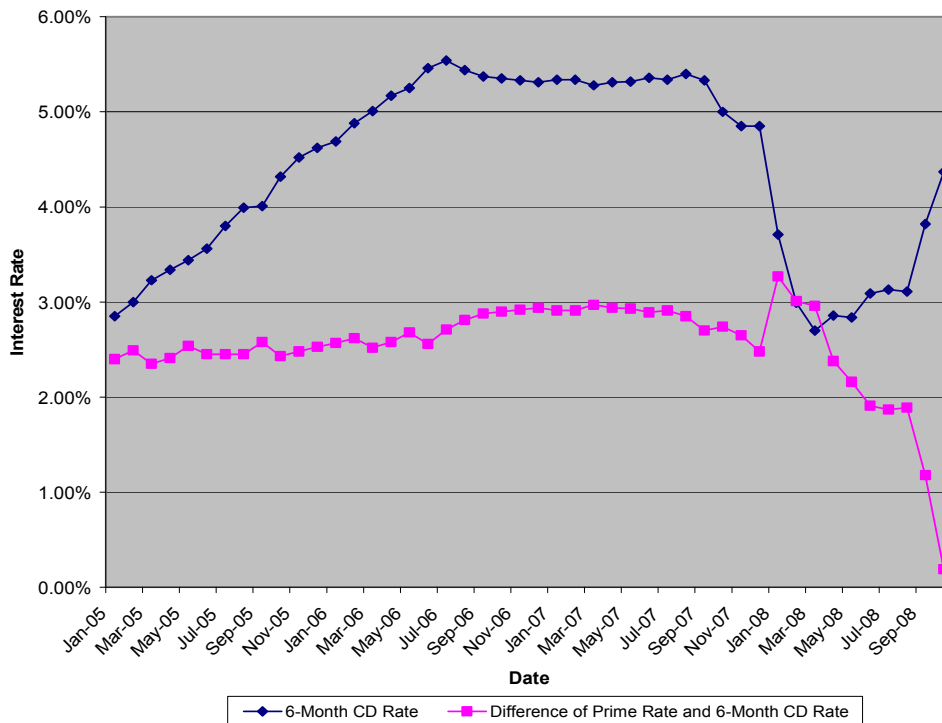
³ The CD rate is from the Federal Reserve Bank's H.15 statistical release and equals the average rate on 6-month negotiable CDs (secondary market), quoted on an investment basis. It is the average of dealer bid rates on nationally traded CDs.

them to affirm and expand the relationship, perhaps by offering additional services tied to their deposit accounts.

- **Consider extending maturities on key funding:** It is also the time to review your bank's rate forecasts and position funding accordingly. Many analysts believe that the extraordinary amounts of current and anticipated Treasury borrowing will ultimately drive both short-term and long-term interest rates higher even with a global economic slowdown. Will foreign investors continue to purchase Treasuries even when they are faced with financial crises as they bail-out banks and related firms in their home countries? It may be time to lock-in longer-term funding whether it's with core deposits or FHLB advances.
- **Raise loan rates and eliminate caps on loan rates, when possible:** With all the attention given to whether banks have cut back their lending, borrowers are focused on the availability of credit and are less sensitive to rate. Where appropriate, take the opportunity to move loan rates (spreads) higher on renewals and new loans and eliminate caps on loan rates that potentially harm the bank when rates increase.

The traditional model of banking in which banks pay low rates on deposits and charge much higher rates on loans is disappearing. Spreads will likely be lower as banks compete with an expanding number of increasingly large banks and non-traditional financial firms. Start planning now for the increased competition.

6-Month CD Rate v. the Difference Between the Prime Rate and 6-Month CD Rate



Tim Koch is the President of the Graduate School of Banking at Colorado. Sign up today for the 59th Annual School Session, July 12-24, 2009. For more information, please contact the GSBC office at 800.272.5138 or www.GSBColorado.org.