The End of Deposits

by Charles Wendel

I recently read two articles that every banker should review carefully. Once read, management should quickly call a meeting to discuss the implications of those articles for the bank and the actions steps that the bank should immediately consider.

The first article (from thefinanser.com) was a blog by Chris Skinner titled, “If deposit accounts disappear, what will banks do?” in which he states, “The traditional bank account is unsustainable long-term.” He quotes the co-head of Deutsche Bank’s Corporate and Investment banking saying, “Technology is impacting the different businesses we are operating in in different ways. There is a completely new normal evolving … there’s a thesis that at some stage in 5, 10, 15, 20 years – who knows – accounts will disappear, and be replaced. That would be a game changer to what we’re doing.”

Skinner also recounts recently speaking with a UK friend who no longer has a bank account: “I asked him how that could be, and he told me about his PayPal life. He opened his PayPal account years ago, with a bank account validation. The thing is that some time after that, he closed his bank account and transferred the balance to PayPal. He took out a PayPal credit card (0% interest for 4 months on all purchases of £150 or more), and has all of his payments paid direct to his PayPal account. He lives on the revolving balance and pays no fees…It made me realise that he had constructed a new way of working with an app and a card.” In short, the digital transformation now underway may change everything.

Banks may want to dismiss Skinner’s view as radical and unlikely, however, another article suggests that even if deposits do not disappear, their cost will rise substantially. Neil Stanley’s evaluation of an FDIC report on interest rate expense (http://www.bankingexchange.com/news-feed/item/7449-big-flip-coming-in-deposit-costs) noted the range of funding costs in the industry, and predicts significantly higher expenses going forward. He also shows that the cost of non-interest-bearing deposits have risen significantly over the past ten years with that rise likely to continue. This be true both for retail and business deposits. If he is right (and he likely is), this has huge negative implications for many banks.

As reported by the FDIC, the range of funding costs is wider than most might have expected: “The cost of funds as of September 2017 ranged from 1 basis point to over 200 basis points for a handful of banks; but the median reported was 43 basis points. Further analysis reveals that 10% of banks had costs of funds below 0.18%, and 10% of banks had cost of funds above 0.80%. Thus this range of 62 basis points in cost of funds covered 80% of the banks in the middle.” Stanley’s analysis shows that “As interest rates dropped, banks that excelled at cost of funds did benefit, but to a lesser extent than in previous environments.” His point is that as rates rise again, the benefit of excellence in deposit gathering will increase in importance. The smartest bankers know this and have been addressing the deposit gathering area after in some cases largely ignoring the value of building a strong deposit base during a lower interest rate environment.

Stanley's article includes one specific paragraph that bankers and Boards should discuss at their next meeting:

"Given the magnitude of funding on the balance sheet, we know that incremental improvements in cost of funds have a very sizeable impact on return on assets and return on equity. The opportunity for high-performance in this category impacting overall bank performance will become greater as the magnitude of interest expense grows."

To put it in my simple terms: rates are rising; rising rates will undercut your returns; what is your bank doing about it NOW? Many banks have been relying on deposit inertia as a strategy with community banks and even business-focused banks depending on customers' deposits remain quiescent. Many (me included) see the low rates all banks are offering and keep their money where it is rather than going through the pain of moving accounts for a few basic points more. But, these banks fail to remember the past during which Merrill Lynch and others aggressively marketed their rates and differentiated themselves, taking significant deposit share. We can already hear the drumbeats of this approach from Goldman Sachs and others. Digital as a channel and, even significantly, as the future customer experience only increases the need to act.

So, what should a bank do? As in many areas consider the basics: people, process, product, pricing and proactivity.

People. Who at the bank is focusing on this? As one bank Chairman says, "Who wakes up in the morning thinking about this?" It is not a committee; it is a person who is a leader and who is on the hook for deposit-related performance.

Process. Look at areas such as account opening procedures and on line access. Other banks have simplified this process while keeping within compliance and regulatory requirements.

Product. Banks need to review their product set and likely add some that address the rising rate environment. Neil Stanley's article suggests three possible products:

- Non-interest bearing demand deposits: Onboarding new clients with simple-to-use switching of direct deposits and automatic payments.

- Non-term interest bearing deposits: Using debit-only interest bearing accounts such as a Companion Deposit Account to provide an attractive market rate of interest to long-term savers without excessively cannibalizing existing deposits.

- Term interest-bearing deposits: Offering Smart CDs which feature the elimination of static early withdrawal penalties that excessively punish depositors for early withdrawal.

Pricing. Related to possible product offerings, consider pricing that helps to maintain deposits and make them sticky even in a raising rate environment.

Proactivity. This is an issue that is not going away. Management that does not have a plan may find that the sale is their best option.

For many banks no other area requires greater focus than funding costs.