Financial Managers Society

fmswhitepaper

First of two parts

Pricing levers for time deposits: strategy

By Neil Stanley, President
Bank Performance Strategies
and Ken Greenberg, President
Austin & Williams

First of two parts

Pricing levers for time deposits: strategy

By Neil Stanley, President, Bank Performance Strategies, and Ken Greenberg, President, Austin & Williams

Overview

While all financial institutions prefer zero or near zero rate demand deposits for funding, CDs invariably make up a large portion of the deposit portfolio. How do institutions price CDs?

Typically, they survey the competition and set one rate for each term that suits their need to fund loans. Yet, this method invariably leads to higher CD interest expense than necessary, simply because whatever the institution's targeted interest rates, worry about losing some of the rate-sensitive depositors (a vocal minority) forces increases in offerings to everyone including the vast (generally silent and complacent) majority. A one-price-fits-all approach creates higher interest expense than necessary.

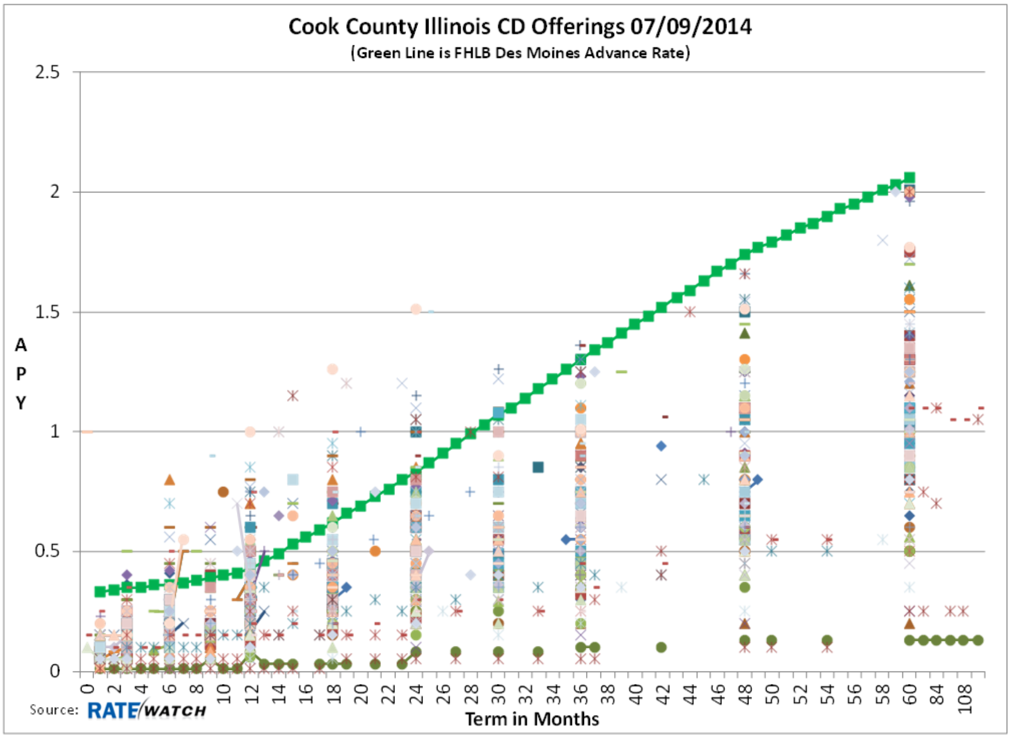
The methods we describe here allow institutions to enhance the product offering and sales process to safely lower CD interest expense by 10-40 basis points with no increase in attrition and a significantly improved concierge-style customer experience. These methods allow for a lower cost of funds for any desired volume of deposits.

Details

A core function of operating a financial institution is pricing loan and deposit offerings. It would seem reasonable to expect that such an important function in the financial industry would be managed using substantial rationale and rigorous processes. If so, what are those rationales and processes, and what would the results look like?

To observe deposit pricing results, we can survey certificates of deposit (CD) offerings (also known as time deposits) in any market at any time. Consider Cook County, Illinois as a representative market. Figure 1 displays the offerings reported to RateWatch as of July 9, 2014 in Cook County. Each mark on the graph represents an offering from one of the financial institutions in this local market. FHLB rates are displayed as the green line for terms of one month through 60 months as a wholesale cost reference.

Figure 1 – Spectrum of Offers within a Market



In looking at this graph anyone can see that there is a wide range of rates offered in each major term. For example, 24-month offerings vary from .01% to 1.51% and average .33%. (FDIC.gov reports that the average 24-month CD offering as of 7/7/2014 was .33%, consistent with our sample market.) The spectrum of pricing observed here is common in most markets. While interest rates will rise and fall and different markets have different competitors, we consistently observe offerings that are so diverse in price that it certainly seems that the managers setting these rates must be using widely differing rationales and processes.

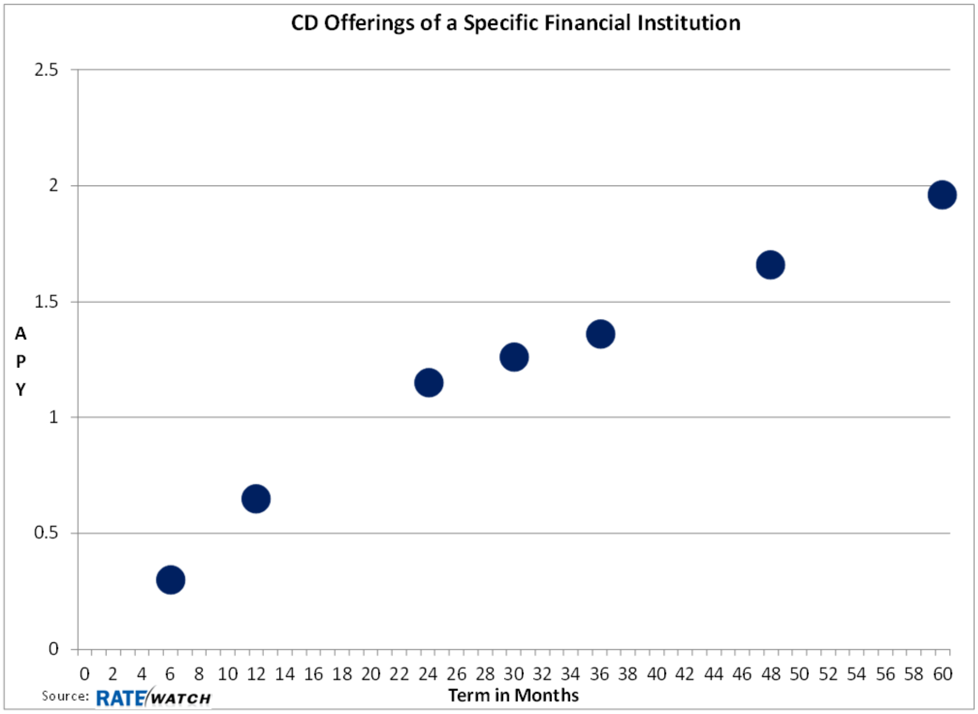
This begs the question: "what would the performance optimizing rationale and processes be for pricing?"

Economists call the demand for deposits a "derived" demand. This is because deposits are the raw material to producing loans. Fundamentally, an institution's willingness to pay for deposits is based on the ability of its bankers to find borrowers willing to pay for loans. Could it be that this explains the diverse pricing differences? That those pricing CDs at higher interest rates simply have more loan customers willing to pay higher loan rates?

Or is it simply that those institutions have higher cost deposits because they somewhat casually decided to offer and accept deposits paying higher rates across the board? While the vast silent majority of CD holders will simply auto-renew at almost any fair rate (inertia, complacency), is ALCO being held hostage psychologically by a vocal minority of rate-sensitive depositors? Could that worry be causing lift on the entire portfolio's interest expense? The short answer is: Yes!

Let's look at what a bit more strategy can do for an organization. Figure 2 shows the offerings of a specific financial institution in the dark blue circles .

Figure 2 – Before Pricing Controls Enhancement



Without a defined consultative sales process that graduates depositors to fresh combinations of service and value, the vocal minority tends to greatly influence where deposit pricing is set. We present in this article a pricing process that has proven to be successful in helping bankers serve more people and make more money by differentiating pricing. This allows depositors to make choices which reflect their personal priorities.

Through an enhanced sales process and redesigned products, institutions can employ more refined pricing controls that address the differing behaviors of the generally silent majority and the vocal minority. Potential pricing for these enhanced processes and products is presented in Figure 3. We now represent the former standard CD offerings in gray circles to contrast with the pricing of the new offerings in dark blue. Using these processes and products provides four pricing controls used to manage a CD portfolio.

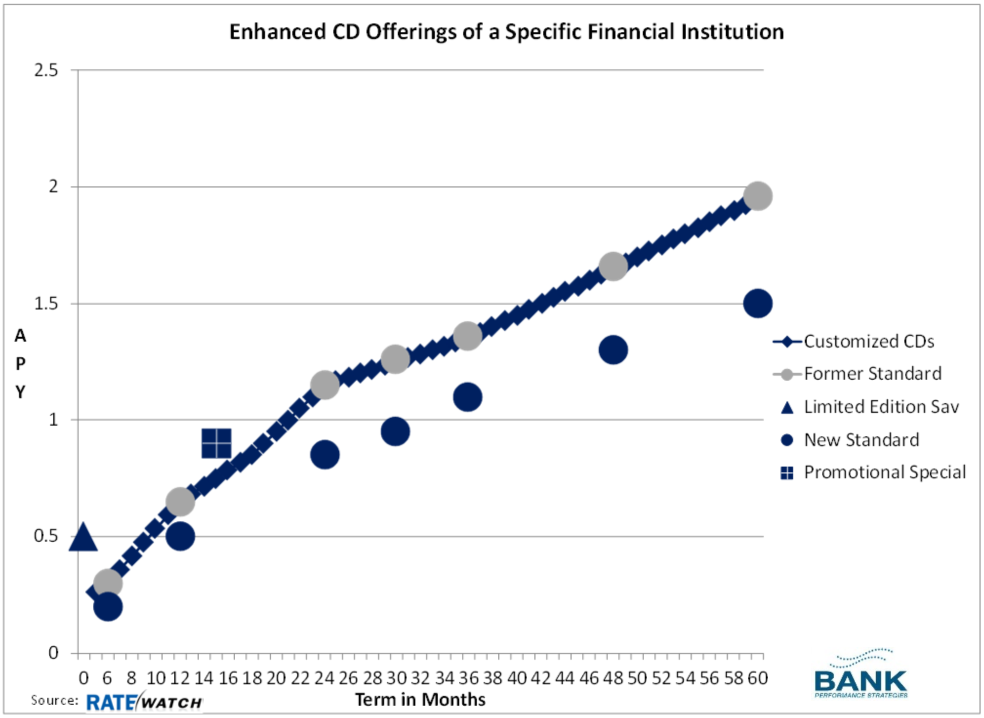
Standard Rates – Pricing for the silent majority
(Fair, published pricing)

Promotional Specials – Pricing to attract new business
(Timed intentionally using analysis)

Customized CDs – Pricing for the vocal minority
(Sometimes used as relationship pricing)

Limited Edition Savings – Offering for the dissatisfied CD holder
(Last line of defense)

Figure 3 – After Pricing Controls Enhancement



Standard Rates

These are the offerings for our standard terms promoted to all customers who are interested. Lower these rates when:

- The institution doesn't have a balance sheet need for CDs.
- Renewal volumes are relatively high.
- Front line staffers aren't selling any/many customized CDs or Limited Edition Savings.

Promotional Specials

These are the selectively used offerings publically promoted for their attractive features.

- Promote these offers externally to potential customers.
- Use when the bank has balance sheet need for growing CDs.
- Price toward the top or at the top of the market.

- Use when low volumes are maturing.
- Use where no or virtually no CDs will automatically renew into new specials.
- Consider grace period consequences.
- Use for a limited time. Don't let these offers become standard expectations for depositors or bankers.

◆ Customized CDs

These are the institution's privately negotiated offerings for preferred customers generally promoted only internally for the front line to determine when to utilize.

- Raise these rates when there is little difference between these and standard rates.
- Raise these rates when the front line bankers are not actively using customized CDs.
- Use in place of relationship pricing.
- Actively coach through the process when individual CDs are lost.

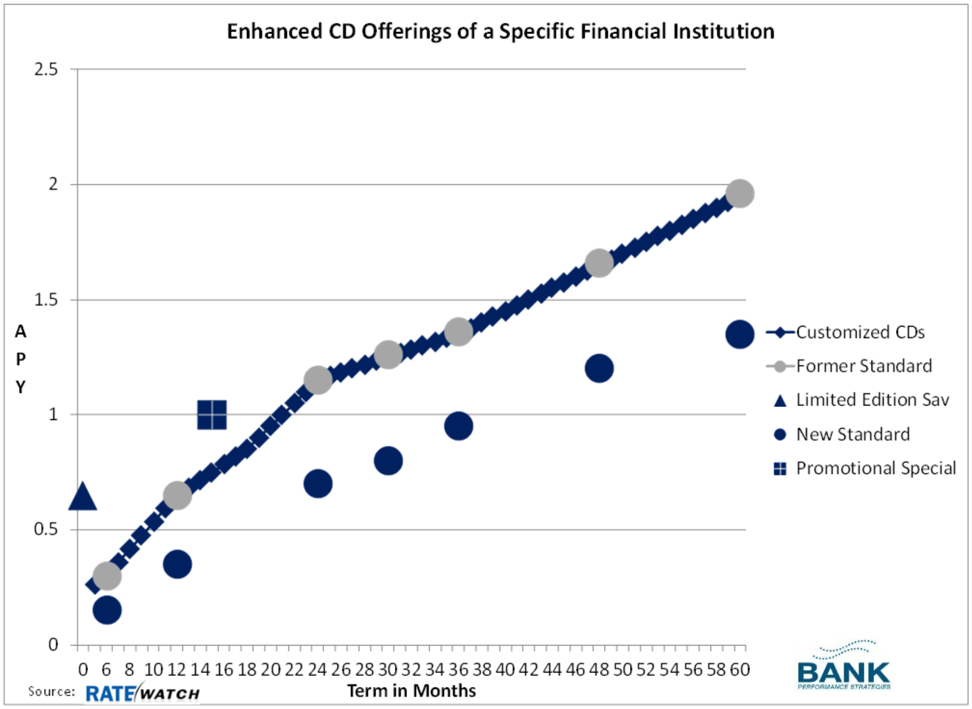
▲ Limited Edition Savings

This is an invitation-only savings account for current CD customers who have money in a maturing CD and have asked for a check to take their money elsewhere. Additional deposits or transfers are not permitted.)

- Raise these rates if losing CD volumes and/or Limited Edition Savings volumes.
- Instead of price matching – offer the ultimate in short term.
- Actively coach through the process when individual CDs are lost.

Using these four levers in conjunction facilitates significant and consistent improvement in profits. Generally, we find that the most profitable implementations trend toward pricing reflected in Figure 4 with lower standard rates. Comparing Figure 4 with Figure 3 you will note that the standard offerings are lower while the promotional special and the Limited Edition Savings offerings are higher. This combination normally helps the financial institution pay less and get more deposits.

Figure 4 – After Pricing Controls Enhancement – Even Better



Whether you are seeking to purge deposits, hold volumes steady, or grow aggressively - the use of these pricing control levers will give you a much more robust and effective process, typically saving 10-40 basis points of CD interest expense.

In addition to profitability improvement, front-line staffer enthusiasm grows as they are equipped and empowered with tools to deal effectively with the silent majority and vocal minority. Specialized training and cloud-based selling tools enable staffers to conveniently offer this concierge-style customer service.

Pricing options shouldn't require institutions to have to choose between making more money and growing business. Use these new pricing levers to enjoy both results simultaneously and revitalize a key element of your business today.

Published by:
Financial Managers Society, Inc.
1 North LaSalle Street, Suite 3100
Chicago, IL 60602
312-578-1300
info@fmsinc.org

http://www.fmsinc.org/WhitePapers
(member login required)

