

Deposit Betas: Looking into the Future

Over the last two years, the banking industry has experienced massive deposit growth, which flooded banks with excess liquidity. Most of the deposits flowed in by way of non-maturity deposit accounts, with a good portion of those funds going into noninterest-bearing accounts. These low cost or “free” deposits helped propel the banking industry’s cost of funds to historic lows and largely put deposit management on the backburner. Rewind to the fall of 2021, and most experts expected one or maybe two Federal Reserve rate hikes in 2022. That was then and this is now. Today (early April 2022), the Fed is expected to raise interest rates anywhere from six to eight times throughout 2022. The pivot from the Fed came rather quickly as inflation levels have stubbornly hovered at or near 40-year highs and the unemployment rate is nearly back to pre-COVID levels.

What are deposit betas?

A very important aspect of non-maturity deposits is the price behavior. Core deposits are typically paid an “administered rate,” a rate that is established by bank management. For most banks, there is usually a weak correlation between changes in short-term market interest rates (Fed Funds or T-Bills, for example). That correlation between the administered rate and the market rates is measured by something called a deposit beta. A classic definition would be that a deposit beta measures how responsive management’s deposit repricing is to the change in market rates. For example, if market interest rates increase 1%, or 100 basis points, and over that same time period bank management increases its savings account rates by 35 basis points, the deposit beta is 35%.

Interest Rate Risk Modeling

Today, most institutions are asset-sensitive and their ability to “lag and drag the Fed” with their deposit rates is critical for increasing their net interest margin in a rising rate environment. Generally, assets such as loans and investments reprice with a

higher beta than deposits. Community banks get the majority of their funding from non-maturity deposits, making deposit betas assumptions key in interest rate risk modeling. Changing deposit betas on one or more large dollar volume deposit accounts can have a large impact on the output of the model. At least annually, management should review their modeling assumptions, especially key assumptions such as deposit betas. Furthermore, institutions should stress test or sensitivity test their key assumptions periodically. An easy place to start assumption stress testing is with deposit betas, specifically non-maturity deposit betas. An example would be to increase all non-maturity deposit betas to a much higher level (i.e. 75%) and reduce the time lags (i.e. one month) associated with the deposit betas. The increase in deposit betas and reduction in time lags will increase the amount of projected interest expense to be paid in rising rate scenarios.

Deposit Beta History

Since 2004, there have been two Federal Reserve tightening cycles. The cycle from 2004 to 2006 saw the funds rate increase from 1% to 5.25%. For community banks (less than \$10 billion in assets), non-maturity deposit betas during that period ranged between 19% and 32% depending on the account type. The most recent tightening cycle started at the end of 2015 and finished at the end of 2018. The funds rate during that period went from 0.25% to 2.50% before the Fed started cutting interest rates in mid-2019 as part of a “mid-cycle adjustment.” During that period, community bank non-maturity deposit betas averaged around 12%, much lower than the previous cycle.

Deposit Betas Going Forward

With the recent start of the latest Fed tightening cycle this March, all eyes are on how aggressive the Fed may be with increasing interest rates to achieve their dual mandate of price stability and maximum employment. As a result, managing

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the liability/deposit side of the balance sheet will come off the backburner and back into focus. The following are reasons for the potential of lower deposit betas in the current cycle.

1. **Liquidity Levels:** As of year-end 2021 call report data, banks continued to sit on over 10% in cash liquidity. With loan-to-deposit ratios as multidecade lows, on-balance sheet liquidity levels are elevated. The need for funding is far lower today than in past cycles. The excess liquidity will allow banks more flexibility in deciding whether to pay up for rate-sensitive customers or allow the deposits to leave.
2. **Capital Ratios:** As deposits and assets grew rapidly during the pandemic, many institutions saw their capital leverage ratios drop to recent lows. Lower capital ratios have made some institutions consider shrinking assets and the runoff of rate-sensitive deposits would allow for that.
3. **Deposit Mix:** Institutions are funded more heavily by non-maturity deposits than ever before. Historically, time deposits cost banks more in interest expense than non-maturity deposits. Less reliance on time deposits should have a favorable impact on cost of funds going forward.
4. **Other Qualitative Factors:** Let's face it...average depositors don't expect much return from their bank deposit accounts. With prolonged periods of historically low interests since the Financial Crisis, many depositors are content with getting a debit card and free bill pay.

During the current cycle, financial institutions' ability to manage their cost of funds is going to be extremely critical given the rapid decline of asset yields the industry experienced during the pandemic. My crystal ball doesn't work any better than anyone else's, but the liquidity and current funding mix in the banking industry should allow for deposit betas and overall cost of funds to remain relatively low.

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