The BakerGroup

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Under Pressure: Deposit Betas in 2023

In science class we were taught that pressure is the application of force against an object. As bankers, we think about pressure as it relates to interest rates versus our deposit rates. Today, bank presidents, CFOs, and other risk managers across the country are focusing on the impact of deposit rates to their cost of funds, net interest margin, and net income. In Asset/Liability Committee (ALCO) lingo, we refer to the deposit "beta" to describe the relationship between deposit rates and their sensitivity to the change in short-term interest rates. A higher deposit beta means higher rates, which lead to higher interest expense and lower margins.

As of November 2022, the Federal Open Market Committee (FOMC) has engaged in the fastest path of rate increases in thirty years. The Federal Funds Rate in February 2022 was 25 basis points. It is currently 4.00% after the Fed hiked rates 75bps the last three meetings, and has cumulatively increased 375bps with a potential peak in rates around 5.00%. Year-to-date, deposit betas have been lower versus historical averages. Looking at multiple rate cycles, deposit betas have ranged from 30-45% while recent analysis indicates betas 20% and less.

Many industry experts have studied the reasons deposit betas have been subdued recently versus past cycles. Some reasons include massive amounts of liquidity, increased regulation, below-average loan growth, higher non-interest costs, and management's desire to maintain margin levels consistent with what they have experienced over the last two decades. Customers are beginning to pay more attention to what they earn on their deposits given the rapid increase in rates and current inflation challenges to keep up their purchasing power. With the increase in competition in the Fin-Tech and non-bank sector, higher deposit betas are expected as the FOMC continues to march rates higher.

The review and analysis of deposit rates and their projected betas is not a one-size-fits-all approach. Variables such as geography and market competition weigh heavily on the sensitivity of these rates. Regionally, East and West Coast areas tend to have higher deposit betas versus regions such as the Midwest. In more competitive markets, we are beginning to see certain products being tied to short-term rates (for example 50% of the prime rate). By tying your non-maturity deposit rates to market rates, you remove the flexibility to manage these rates in a rising rate environment. Another factor in betas is institution size. Community banks have been slower raising rates than larger banks but could potentially be forced to play catch up if they lagged earlier this year.

A positive trend we see with bank management is they are spending more time improving and incentivizing their deposit operations departments. With the potential of deposit outflows, it is important to recognize this group in their efforts to provide the bank with low-cost funding, which can then be deployed into earning assets such as loans and securities. ALCOs are instituting new customer loyalty programs and improving customer relationship training with commercial and other large balance accounts. Given this trend, here are some ideas to help manage your bank's deposit betas:

Thoughts on Lower Deposit Betas

- Target certain rate advertisements, focus on quality of service and products offered
- Revisit all deposit product tiers and mange tier pricing independently
- Focus on certain market demographics with lower deposit beta behavior
- Increase education of client relationships through education and incentives
- Enhance cross-selling efforts and customer loyalty programs

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If your bank experienced higher betas this year, how much will it take for competition to catch up? On the other hand, if your bank lagged market competition, are there risks of deposit outflows? If loan demand is picking up, how long can the bank support these growth levels with higher funding costs? As ALCOs think about these questions, remember there are many reasons other than interest rates that customers choose to deposit their funds at the community bank. Studies have determined that consumers place higher value on attributes such as convenience, service, availability, and technology over deposit rate pricing. However, now that some online savings accounts are yielding close to 3%, this could cause a change in priorities.

When thinking about deposit betas in your asset/liability model, keep in mind that assumptions have limitations versus what actually happens. Because of this, prudent risk managers will periodically stress these assumptions and establish worst-case scenarios to analyze the impact to bank earnings and capital, given higher deposit betas. If your bank has not been talking about these concepts, now is the time to do so. Taking time to revisit these important interest rate risk concepts, adjusting your ALM model inputs, and stress testing are all steps to better prepare for a successful exam with regulators.

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