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Deposit Betas Remain a Challenge in 2024

We do not have to go back very far to remember a time when deposit betas were not even an agenda item in many Asset Liability Committee (ALCO) discussions. Today, the topic is front of mind for many, especially as the interest rate cycle is anticipated to turn over in 2024 and a new period of falling rates is expected to begin. In banking lingo, the term "beta" refers to the sensitivity of a bank's deposit costs to changes in the short-term interest rate. In other words, how much of a move in the short-term rate (federal funds rate) rate a bank passes on to depositors.

The matter is front of mind because the rapid acceleration of betas was a major theme in 2023 for many banks. By and large, community bank betas increased rapidly every quarter from Q2 2022 through Q2 2023 and then began to moderate as Fed rate hikes ceased in July 2023. Despite the recent moderation, betas continue to present a challenge. Many expect betas to continue to rise, albeit at a slower pace, and then peak some time in 2024. Pressure to pay more for deposits at a time when loan growth is also expected to slow alongside a slowing economy will be a challenge for many.

We ended 2023 with deposit costs rising faster than loan yields for many institutions. The rapid increase in interest rates since March 2022 as well as the impact of rising inflation on depositors' purchasing power has had customers paying considerably more attention to what they earn on deposits. Unfortunately, this shift in consumers' mindsets may have lasting implications, making it more difficult to bring down deposit costs when the rate cycle expectedly turns over this year. In previous cycles, one of the best defenses against shrinking margins has been the ability to aggressively cut cost of funds. However, banks' increased use of wholesale funding and the reawakening of so-called "sleepy" deposits may render this strategy ineffective this time around.

Slowing loan growth also poses a challenge for many in 2024. High borrowing costs and weakening economic conditions may be a headwind for loan demand this year. Many bankers are also tightening lending practices in preparation for a less favorable economic environment. Recent bank lending surveys conducted by the Fed show that many banks have tightened credit standards across all product categories and show that they anticipate a deterioration in credit quality as well as collateral values in 2024.

The persistence of elevated deposit costs combined with slower lower growth would understandably challenge net interest income (NII). So, what can banks do to combat these pressures in 2024?

Ideas to Help Manage 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

Ideas to Help Offset Slowing Loan Growth

- Supplement decreased loan activity with investments
- Avoid keeping investments in cash/short-end of the curve as those will be the first to fall when the Fed cuts rates
- Consider extending duration to lock in higher asset yields for longer
- Be creative if liquidity is tight; consider bond swaps/ borrowings to capture higher yields
- Pull forward investment purchases to secure higher yields by "pre-refunding" future cashflow that would otherwise mature

These broad themes will not impact every community bank the same way. Nor should every community bank approach its beta

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analysis the same way. Variables like geography, competition, size, and funding mix all weigh heavily on betas. There has been an important and necessary shift in focus on this topic, with many banks devoting more time and resources to proper analysis and projections. Prudent risk managers will also periodically stress the assumptions around deposit betas in their asset/liability models and establish worst-case scenarios to assess the impact of higher betas. This is a necessary step in today's environment, especially in preparation for a successful regulatory exam.

Also remember there are many different reasons that customers choose to deposit their funds at a bank, which are not dependent on interest rates. Past studies have shown that consumers place higher value on service-related features like convenience, customer service, availability, and technology over deposit pricing. Those surveys may underestimate the rate impact now that many online banks are offering savings accounts that yield well over 4.0%. However, there is still much community banks can do to protect NII in 2024.

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