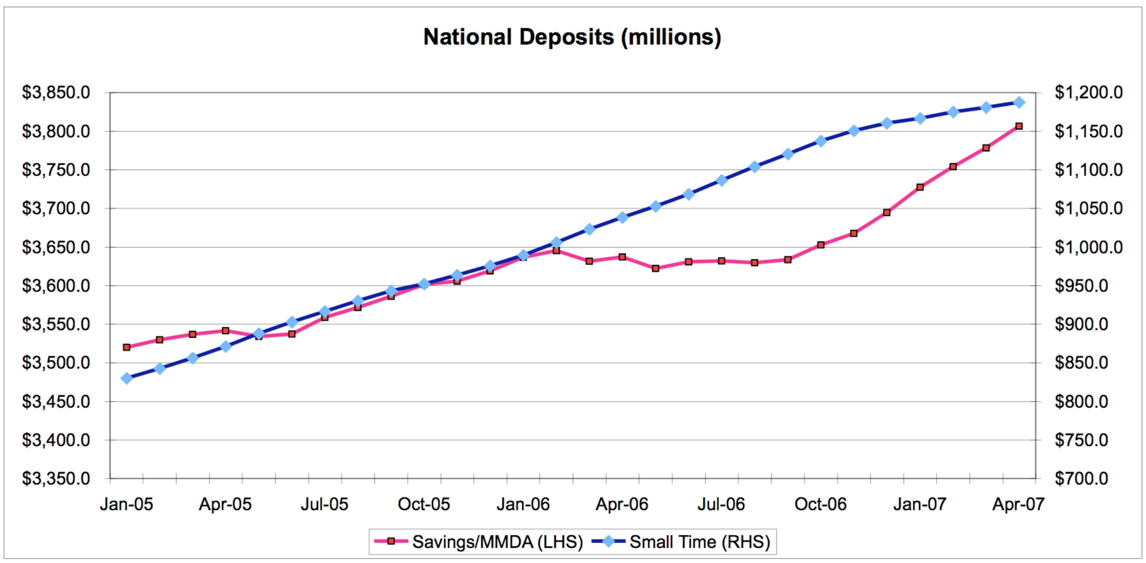
How Insensitive Are Retail Deposits, or
Who is Smarter Customers or Bankers?

Those of us in the Asset/Liability field have been pleased at having a real world laboratory over the past three years since the Federal Reserve began its tightening campaign. Interest rates, at least short-term ones, have been on a multi-year uptrend, allowing observation of both customer and banker responses. Furthermore, the stability in rates over the last year of the period has introduced an additional variable into the equation. This article will explore the interesting interplay between rates, deposit balances, and the choices made by both depositors and bankers.

<u>Do rates matter for non-maturity deposits?</u>

If there is one truth that all bankers hold dear, it is the insensitivity to rate change in non-maturity deposits. Many a time I have heard a banker state, "We don't have to raise the rate on savings because all that will do is cause the customer to wake from their sleep."

We can gauge the accuracy of that statement by asking whether customers move their funds when confronted by rate differentials. The chart below suggests that they do.



Note that Savings/MMDA deposits began the period (early 2005) with a bit over $3.5 trillion in deposits. But as banks dragged their feet in raising rates on these categories, the deposit totals stagnated. By the time the Fed was done with tightening in June 2006, Savings/MMDAs had advanced only about $100 billion or less than 3%.

Bankers had raised rates on CDs, however. Six-month rates had increased from 1.0% in May 2004 to 2.3% by May 2005 and to 3.2% by May 2006. Consequently, CD balances increased from $875 billion to $1,075 billion by June 2006. This rate of increase over the same period was north of 20% and in dollar terms was double the increase in Savings/MMDA.

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Note that since late 2006, CD rates have stagnated and many banks have reluctantly begun catching up their Savings/MMDA rates to more market levels. As we might expect, customers have re-established their love affair with immediately available funds.

Who makes the choice?

There is another extremely important point relating to retail CDs. Since banks have to post rates, obtain marketing materials, and keep branch staff trained and comfortable with the products they are selling, retail deposit rates have a pretty high level of persistence both up and down. In fact, most studies that I have seen suggest that retail CD rates take about six months after a change in rates to settle down into an equilibrium.

If this is the case, we would expect that customers would be able to take advantage of the lag in rates at turning points in the interest rate cycle. As we have seen above, when banks are slow to raise a particular rate, customers shift to different categories. When they are slow to lower those rates, dollars flow in dramatically. The following table shows the costs for IBANYS members annually over an entire interest rate cycle for both retail CDs and wholesale CDs.

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*Average*
Retail	5.50%	5.79%	3.74%	2.85%	2.46%	3.08%	3.96%	3.91%
Wholesale	5.94%	5.05%	3.01%	2.48%	2.18%	2.94%	4.24%	3.69%

There are two important points to take away from this table. First, the facts suggest that wholesale funds are cheaper than retail over the entire rate cycle. Second, there are distinct times when one category is cheaper than the other. Let's look at both points in more detail.

Even before the costs of handling retail CDs, we see that the interest cost is higher than that on wholesale CDs. How could this be the case? Recall that whenever a banker buys a wholesale CD whether local, municipal, or brokered, there is a bidding process involved. This means the decision on whether to acquire the funds is made individually on each transaction. Both rate and term are set by the banker. (Although you may be forced to bid on a particular maturity by a local customer, you always retain the ability to bid high to win or low to lose.) Retail CDs are completely different. The customer is making the choice that the banker makes on wholesale CDs. Not surprisingly, customers are not stupid. They will take advantage of rates that are higher than they should be and will extend maturity when the rate cycle is heading down. Because of the difference in who is making the decision, the costs of the two categories develop a permanent advantage in favor of who is doing the choosing. Banks choose on wholesale while customers do on retail.

At what point in the cycle does the extra cost of retail peak? A review of the history of rates this century in the table suggests that retail is most costly just as rates peak and head downward. Note the cheaper retail costs in 2000 as rates were still headed up and the sharp reversal in 2001 and 2002 as the easing cycle took place. A good question to ask is whether 2006 will be a lot like 2000, creating a real cost problem for banks over the next year or so if rates do head down again. In other words, will the benefit from lower rates that bankers expect from their Alco models be subverted by customers making a choice to extend maturity just when relief could be expected?

No one can predict the course of interest rates with certainty, but armed with the knowledge that customers are pretty savvy in moving their dollars to the most advantageous options, bankers can change their tactics. Perhaps, now is the time to try to capture some Savings/MMDAs while using wholesale funds as a substitute for aggressive pricing on retail CDs.

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