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# Composition shifts a focus as industry approaches interest rate hikes

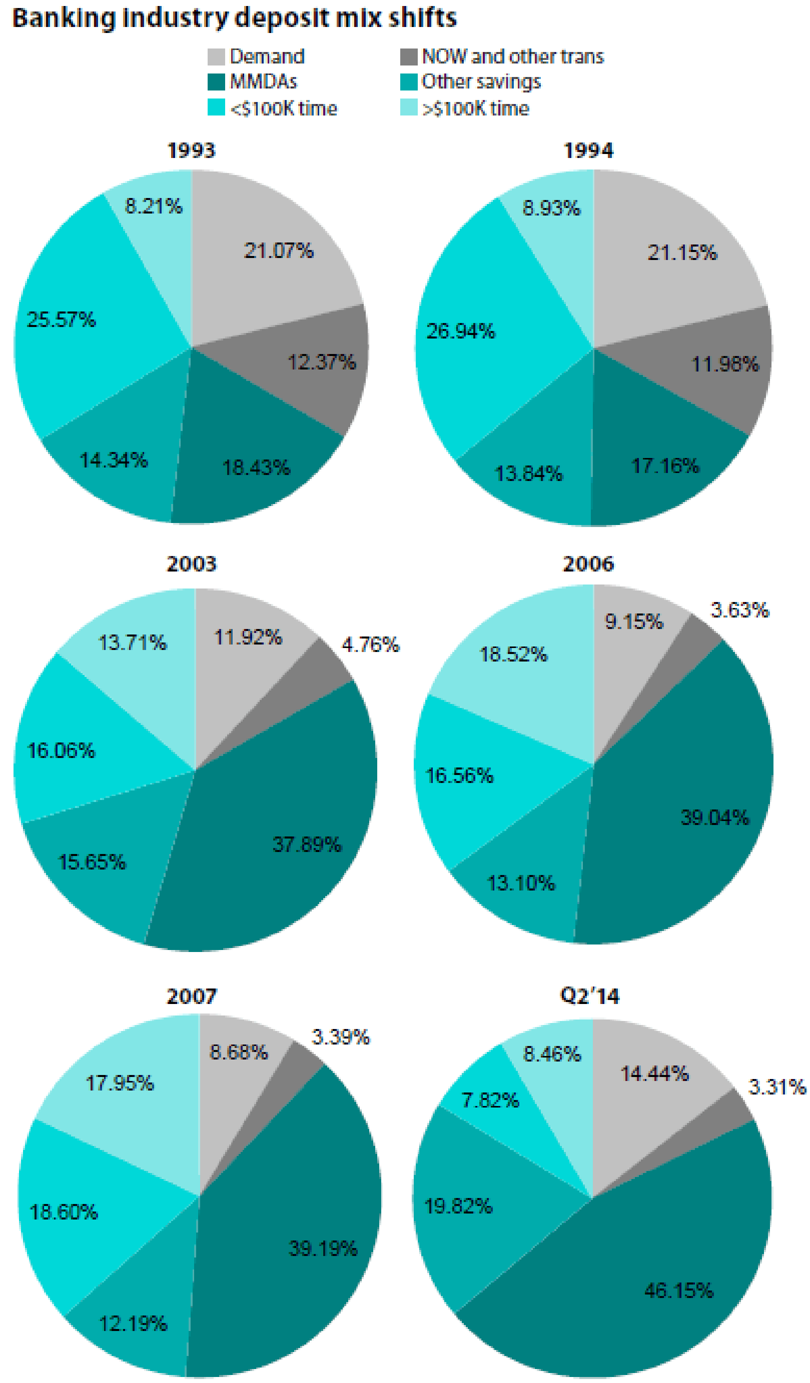
By Robb Soukup and Salman Aleem Khan

As the industry moves toward a shift upward in rates, banks and industry observers are studying previous rate cycles which hold some surprising lessons — though the rate environment remains unprecedented.

Interest rate risk is a major concern across the banking world at the moment for bankers, regulators and investors, with industry observers expressing concern about the potential for rapid shifts in liquidity when rates begin to rise – which many have forecast to happen as soon as mid-2015. After a prolonged period of the Federal Reserve holding rates at essentially zero, and a concurrent flood of liquidity into the banking system, many investors and bankers are worried that as rates rise, liquidity will reverse and leave the banking system and cause major funding pressures for banks.

Experts who are helping banks prepare for the interest rate changes say, however, that previous interest rate cycles are more associated with liquidity composition shifts rather than declines. "A lot of people are worried that liquidity is going to significantly move out of the banking environment," Matt Miller, an executive managing director with FinPro Inc., said. "When we went back and looked at it, it wasn't that liquidity moved out of the banking environment — in fact, deposits actually grew — what happened was that deposits shifted," he added.

Miller said that what is important for banks, then, is to understand the loyalty of its deposit customers, and how composition shifts will impact interest expense as rates rise.




As of Oct. 15, 2014.
Includes commercial and savings banks. Savings institutions were excluded in periods prior to 2012 due to lack of disclosure.
Excludes foreign deposits.
Source: SNL Financial

And while nailing down how interest rates will impact the balance sheet will be a difficult task for banks, they have a head start thanks to regulators and others in the industry who have pushed banks to focus on the issue well in advance of when rates are projected to rise. "It's a little bit more challenging in terms of the rate environment, but the tools that the industry has at its disposal are a lot better, and I think the implementation has been a lot better, because of the requirements in the interagency guidance and feedback that banks have been getting in their exam cycles," Eric Schwartz, a director with Promontory Financial Group LLC, told SNL.

"This is an area where for the first time we really feel like our clients are ready for a rate rise. I'm not sure we ever have been, or have been as proactive as we have been," Donald Musso, the president and CEO of FinPro, said. "I'll give some credit to the regulators: they have been sounding the interest rate horn for the last year or so," he added.

**Deposit mix change at the largest banks**

| Company (top-level ticker) | Q2'14 total domestic deposits ($B) | 2007-Q2'14 deposit concentration change* (pps) Demand | NOW & other trans | MMDAs | Other savings | <$100K time | >$100K time |
|---|---|---|---|---|---|---|---|
| Bank of America NA (BAC) | 1,046.21 | 3.17 | 0.88 | 8.47 | 10.63 | -11.70 | -11.45 |
| Wells Fargo Bank NA (WFC) | 1,033.62 | 7.10 | -0.71 | -2.49 | 3.87 | -3.29 | -4.48 |
| JPMorgan Chase Bank NA (JPM) | 1,032.55 | 7.78 | -0.16 | 11.84 | 1.28 | -4.94 | -15.80 |
| Citibank NA (C) | 453.77 | 6.96 | 0.45 | 8.33 | -0.73 | -5.72 | -9.27 |
| U.S. Bank NA (USB) | 263.66 | -4.70 | -0.55 | 12.11 | 8.97 | -7.30 | -8.54 |
| PNC Bank NA (PNC) | 221.11 | 2.73 | -1.21 | 11.72 | 2.39 | -11.10 | -4.53 |
| Capital One NA (COF) | 191.20 | 1.02 | -0.14 | -19.81 | 40.08 | -12.99 | -8.17 |
| TD Bank N.A. (TD) | 185.61 | -1.29 | -1.63 | 22.61 | 2.12 | -15.01 | -6.81 |
| Branch Banking and Trust Co. (BBT) | 137.82 | 6.31 | -0.97 | 15.72 | 1.53 | -16.25 | -6.34 |
| SunTrust Bank (STI) | 136.87 | -0.17 | 0.37 | 25.84 | 1.05 | -8.95 | -18.14 |
| HSBC Bank USA NA (HSBA) | 111.13 | 25.37 | -0.40 | -12.23 | -1.06 | -0.34 | -11.32 |
| Fifth Third Bank (FITB) | 97.69 | 7.75 | -1.16 | 16.00 | -6.21 | -9.02 | -7.37 |
| Regions Bank (RF) | 96.09 | -0.13 | 2.40 | 19.89 | 2.48 | -13.13 | -11.51 |
| MUFG Union Bank NA (8306) | 81.23 | 8.42 | -1.66 | 4.61 | 2.27 | -0.40 | -13.23 |
| BMO Harris Bank NA (BMO) | 72.63 | 4.93 | 0.45 | 19.89 | -5.28 | -3.24 | -16.74 |
| Manufacturers and Traders Trust Co. (MTB) | 70.79 | 4.47 | -0.59 | 20.52 | 0.61 | -14.03 | -10.98 |
| KeyBank NA (KEY) | 69.30 | -1.29 | 0.29 | 22.54 | 0.99 | -13.69 | -8.83 |
| Citizens Bank NA (RBS) | 68.76 | 5.00 | 1.63 | 7.40 | 11.84 | -15.25 | -10.62 |
| Compass Bank (BBVA) | 58.23 | 5.05 | -0.15 | 2.04 | 2.25 | -6.06 | -3.14 |
| Ally Bank (ALLY) | 56.30 | -0.08 | 1.71 | -22.93 | 23.25 | -20.88 | 18.93 |
| **Top 20 median** | | **4.70** | **-0.16** | **11.78** | **2.19** | **-10.06** | **-9.05** |

As of Oct. 15, 2014.
Analysis includes the top 20 commercial and savings banks by total domestic deposits, with a loans-to-deposits ratio of greater than 40% and a credit card loans-to-total loans ratio of less than 50%, as of June 30, 2014.
USAA Federal Savings Bank and Goldman Sachs Bank USA met the criteria to be included in this chart, but were excluded due to unavailable deposits-related data in 2007.
* Data reflects the percentage-point change in concentration for a given deposit type since Dec. 31, 2007.
Excludes foreign deposits.
Ticker is based on home country stock exchange.
Source: SNL Financial

Still, there are some key and major differences between the rate cycle that is approaching and previous cycles. For the industry's largest players, perhaps the key development has been the implementation of liquidity coverage ratio, which is intended to help systemic banks weather a liquidity crisis, and dictates certain assets as highly liquid and high-quality. "One impact of the LCR of course is that a larger percentage of bank balance sheets will be in so-called high-quality liquid assets — which by virtue of the fact that they are high quality are typically lower-earning assets — so right there you will have certain [net interest margin] pressures that you hadn't had in previous cycles," Schwartz said.

That has forced those banks to not only adapt to LCR on the fly, but also look out to a changing interest rate environment and "thinking about their funding compositions and how they can term out their funding, but also … thinking about the composition and overall structure of [their] liabilities to optimize [their] investments and [their] liabilities in LCR-efficient sources," according to Schwartz.

But perhaps the biggest difference — and worry — for both the largest banks and the rest of the industry is the unprecedented rate and policy approach that has created the current rate environment. Between the Fed parking its fed funds rate at essentially zero for more than five years, as well as purchasing trillions in assets, there is a large element of uncertainty about how the financial system will respond to shifting rates.

As a result, Miller said that FinPro has advised and worked with its community bank clients to go beyond simply looking at deposit betas and decay rates. "What we're saying is that that's just not good enough anymore, because we've been at such a low end of the rate cycle," Miller said. Instead the firm has helped clients undertake a much more granular and detailed analysis of its deposit relationships. That will let those banks to both understand the value of the underlying relationships and, when rates do rise, allow some of the less desirable accounts to come off the balance sheet to be replaced by longer-term funding from Federal Home Loan Banks and other sources.

"The biggest thing that we have to account for is that we've never been in this low of a rate scenario," Musso said, adding that with rates having busted through their historical bands, it is difficult to forecast how deposits and banks will behave "because we don't have any historical context under which to view it."