The Changing Face of Retail Deposit Growth
Certificates of Deposit Revive

Retail deposit growth in 2005 is showing a much different path than it had in the previous ten years or so. With the Federal Reserve in a multi-step tightening mode, interest rates have moved to the point where bank and customer behavior has changed. This article will examine what is happening, offer some thoughts as to why, and take a stab at some strategies that a community bank can explore in response.

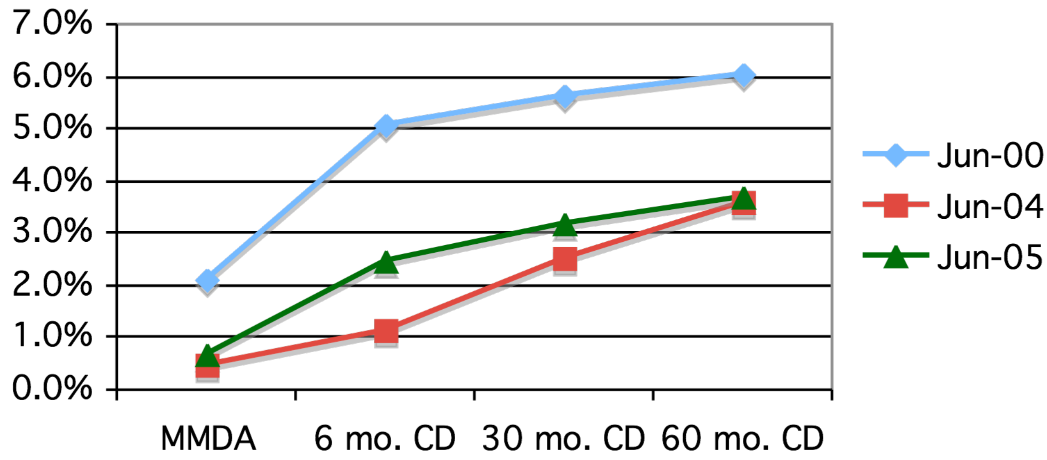
<u>What's going on in core deposit land?</u>

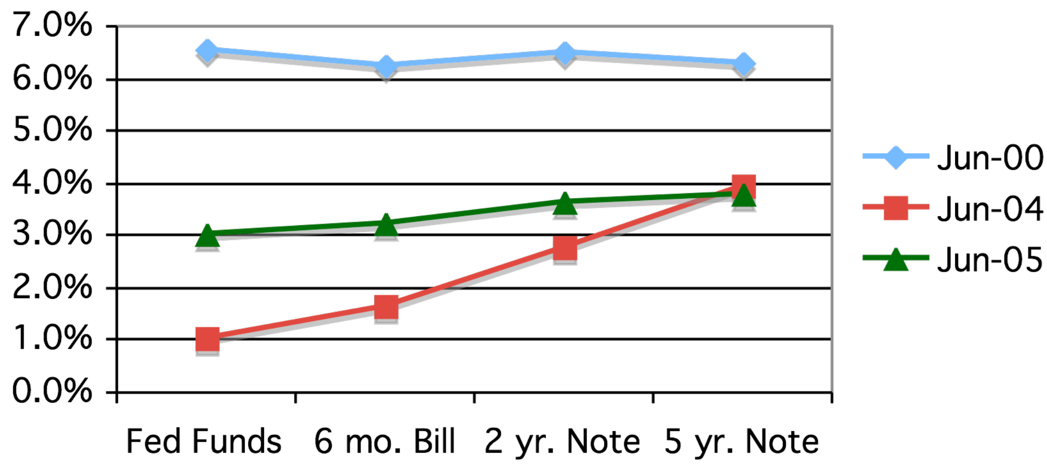
The relationship between retail CD totals and the combination of savings and MMDAs held remarkably stable from the mid-1980's to the mid-1990's. Each category tended to range between a low of about $700 billion and a high point of $1.1 trillion. In fact, retail CDs have continued to stay within that range over the past ten years. The real change in bank deposits has been the dramatic upsurge in savings/MMDAs. Starting in 1995, this category rose to roughly $1.7 trillion by the end of the century and then doubled to $3.5 trillion by year-end 2004. This means from rough parity ten years ago, the more liquid but generally lower yielding savings/MMDA totals quadrupled while retail CDs stayed stagnant.

It's hard to know exactly what caused the dramatic divergence in the different categories of deposits, but it is safe to say that many factors should be considered. Customer preference for accounts that could be accessed immediately while still generating decent returns are surely part of the reason. Furthermore, the consistent decline in interest rates over the last decade also played a role. As a consumer, I will be reluctant to lock in for term when rates look lower than they have been historically. Another contributing factor may have been funds exiting the stock market collapse in 2000 and 2001. Perhaps it was parked waiting to re-enter. The last factor that has been suggested is that the wave of refinancing and home equity extraction caused consumers to place money in quickly accessible accounts temporarily while they were waiting to use the funds.

Regardless of which factor you consider to be most important, all seem to be reversing. The stock market, although not rising dramatically, is no longer falling like a rock. Mortgage refinancing is down sharply from 2004, while home equity rates are now in excess of long term mortgage rates. The spread between MMDA rates and CD rates has widened. And the general level of rates has increased, encouraging some consumers to lock in to capture the higher returns. (See charts below.)

The Changing Face of Retail Deposit Growth
Certificates of Deposit Revive

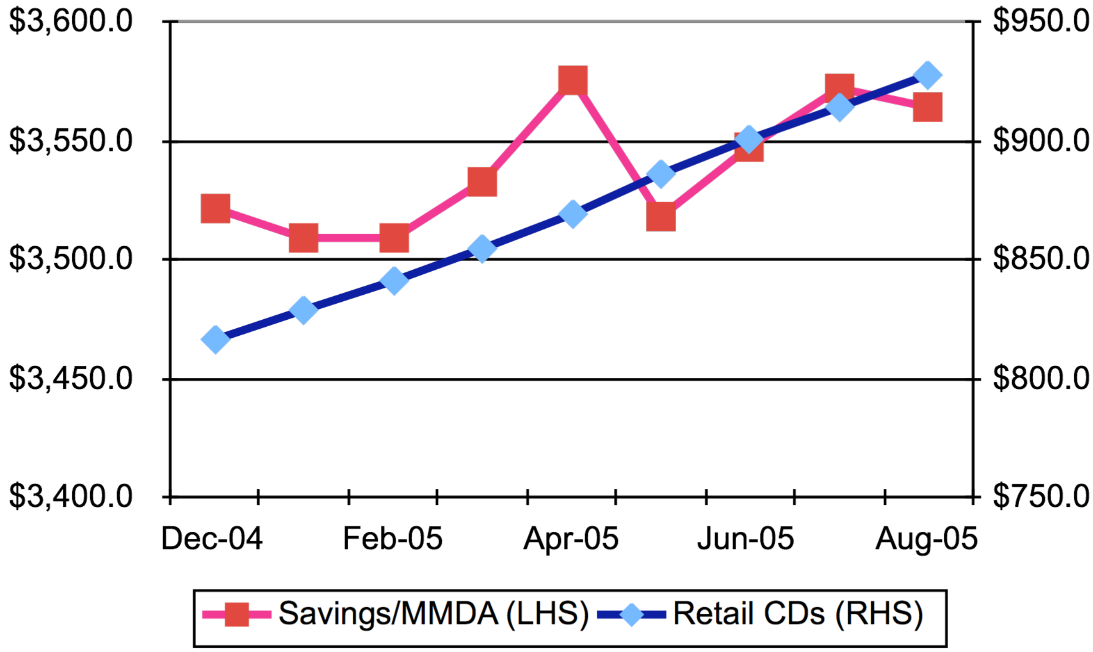




Note what is conspicuous on these charts. Although market rates showed a dramatic drop in short rates relative to long rates from the end of Fed tightening in June 2000 to June 2004, MMDA rates actually fell by the least amount of any of the deposit categories. Since June 2004 as the Fed has tightened, the opposite has occurred.

This means that consumers may have flocked to MMDAs between 2000 and 2004 because they saw those rates as holding up more than CD rates and did not want to lock in at lifetime lows. Now with term rates leading the upsurge, we can expect the opposite. And indeed, the worm has turned in the relative growth rates of the deposit categories. Note the chart below.

The Changing Face of Retail Deposit Growth
Certificates of Deposit Revive



As we can see, there is a different dynamic in consumer deposit choices. Money is now flowing into CDs while savings/MMDA growth has slowed.

<u>What does the future entail?</u>

It would be hard to predict that CDs will catch up to savings/MMDAs any time soon. The gulf is too large to be reversed in one year's time. After all, it took ten years and some historically unlikely events to create the imbalance. However, the momentum is clearly in the direction of certificates of deposit at present, and as long as banks pay up for CDs instead of MMDAs, the trend will continue.

There are two ways to react to the situation — play the contrarian or jump aboard the bandwagon. Both strategies require a view on the direction of interest rates. Let's look at both options.

If you feel that the Federal Reserve is still some distance from the end of the tightening cycle and that rates will continue to rise into 2006 and perhaps beyond, putting a big rate on a CD with as long a term as you feel you can sell makes sense. A two or two and one-half year market rate borrowing might be priced in the high 4% range or even at 5% by the time you read this article. That offers the chance to use 5% as your marketing hook. With depositors having been starved for yield and now looking for CDs, the sale may be easier than you think.

Conversely, if you feel the Fed is close to the end or has even gone too far and is risking a recession, choosing a short term and really paying up makes sense. For example, if you pay 4% for three or four months (targeting a maturity in the holidays or the middle of winter), you may capture money that is not that costly while minimizing the chance of having to raise the cost of the entire MMDA category. For this option, it probably makes sense to set a high minimum.

The Changing Face of Retail Deposit Growth
Certificates of Deposit Revive

Note that when the market moves from simply parking funds to seeking high yield as it has begun to do over the past year or so, you as bankers must change strategies. The trick today is to protect the dollars in the lowest cost category without raising rates by having a good alternative for those who wake up to the fact that you are still below 1% on savings/MMDAs. And with the market moving to CDs, that is the place to go.

Michael Jamesson heads Jamesson Associates, a consulting firm located in Scottsville, N. Y. that specializes in balance sheet management, merger and acquisition analysis, and strategic planning for community banks.