yearly Outlook

Deposit Trends and Analysis for 2013

Synopsis

The banking industry will continue its transformation in 2013 along two axes - from processor to provider and from brick to click.

The three major drivers of this transformation are shrinking interest margins, technological advances and changes in the financial lifestyle of consumers.

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A PARADIGM SHIFT IN THE BANKING INDUSTRY

In 2013, we will see an acceleration in the transformation of the banking industry along two axes - from processors to providers and from brick to click (Figure 1).

Initially, this transformation will be more evident on the deposits side because of the widespread use of checking accounts and payment methods, but gradually this transformation will spill over to the loan side as well.

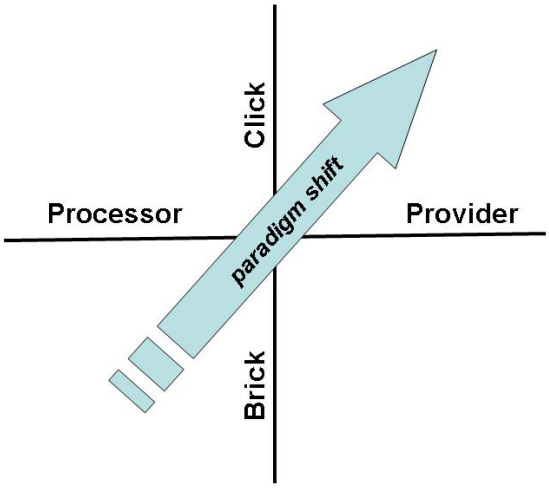
From Processor to Provider

Traditionally, financial institutions were structured to process transactions for their customers. Processes such as checking transactions, credit or debit payments and fund transfers were the focal point of the banking system on the deposit side.

Although this function will continue to be at the core of what financial institutions do in the back of the house, the role of banking in the eyes of consumers is gravitating towards becoming a provider of financial services that support emerging lifestyles.

The change in consumers' perception of the role of their financial institution is evident in the national research study recently conducted by Market Rates Insight (Figure 2)

Figure 1 - The new banking matrix



The findings of the study clearly show a very high level of desire for financial services that support consumers' new lifestyle such as cyber security, mobility, efficiency and convenience.

In addition, the study reveals that consumers place a value on these services with their willingness to pay a monthly fee in return. Contrary to "traditional" fees such as ATM and debit-card fees, which consumers view as punitive fees, they view these emerging services as enhancement to their lifestyle and an added value worth paying for (More on page 3).

Figure 2 - Findings from the consumer study on Lifestyle Financial Services

Financial services	Overall likelihood of use (%)	Overall monthly fee ($)
Identity Theft Alerts	82.5%	$4.07
Credit Score Reporting	73.7%	$3.39
Personalized Couponing	69.2%	$3.88
Overdraft Transfer Service	67.9%	$4.20
Person-To-Person Payments	66.2%	$3.31
Mobile Remote Deposit Capture*	63.4%	$2.37
Prepaid Reloadable Cards	47.1%	$4.21
Average all services	**67.1%**	**$3.63**

**Per deposit*

A PARADIGM SHIFT IN THE BANKING INDUSTRY

From Brick to Click

There are two main reasons for the gradual transformation from brick to click - external and internal.

The external factor is the growing use of online and mobile banking by consumers in general and by Gen X and Gen Y in particular. Every year that goes by adds more "cyber banking" customers to the market. Eventually, the cyber-banking segment will be the largest group of banking customers.

The internal factor has to do with cost structure. The number one and two expenses for branch banks are payroll and facilities. Since, by their nature, Internet banks compared to branch banks have much lower payroll and facilities expenses, they can afford a slightly higher expense on interest on deposits.

These cost differences are inherent in the business model of the two types of banks. Thus, we will see more and more branch banks shifting functionality online and reducing the overhead expense associated with branch distribution. This does not mean that branches are going to disappear altogether. However, the number of branches will gradually decrease as the percentage of baby boomers decreases and the cyber generation increases.

Competitive advantage

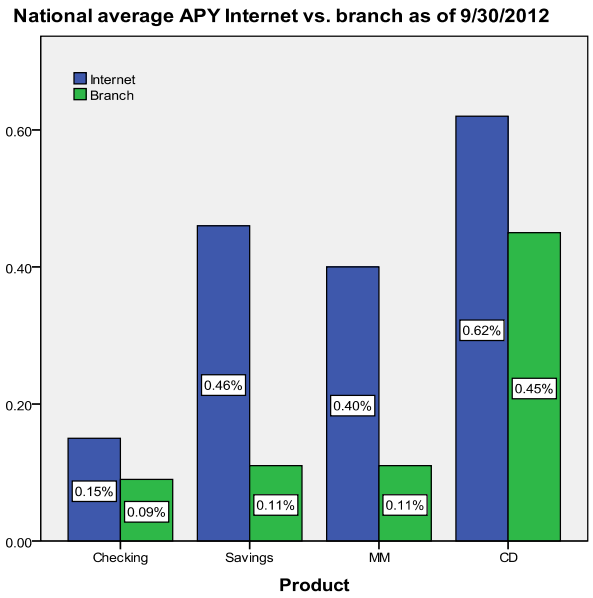
Branch banks will have to become more rate competitive in the future. The average interest rate paid by Internet banks for all deposit types is 0.41% compared to 0.19% at branch banks. For some deposit types, such as savings, Internet banks pay four times the rate paid by branch banks – an average of 0.46% at Internet banks compared to 0.11% at branch banks.

For Money Market accounts, Internet banks pay an average rate of 0.40% compared to an average of 0.11% by branch banks. The average rate for certificates of deposits of all terms at Internet banks is 0.62% compared to 0.45% at branch banks (Figure 3).

In the fist nine months of 2012, the gap between Internet rates and branch rates has widened. Although both Internet banks and branch banks lowered their deposit rates during this time period, the overall decrease in branch rates was greater than in Internet banks thus making the gap between the two types of banks greater.

During the first nine months of 2012, the national average interest rate at Internet banks decreased by 0.01% while branch banks lowered their average interest rate by 0.03%. Internet banks are banks that operate purely on the Internet and have no branch network. Branch banks are brick and mortar banks operating a network of branches.

Figure 3



CROSS-SELLING STRATEGY - A KEY TO SUCCESS IN 2013 AND BEYOND

Cross-selling products to your customers is a proven strategy for generating non-interest income. Since interest income is not likely to recover in 2013, offsetting some of the decreases in interest income with non-interest income is a wise strategy.

In a recent interview with FORTUNE magazine, Wells Fargo CEO, Mr. John Stumpf, stated the following about cross-selling:

FORTUNE: "Every business likes cross-selling, but why is it your strategy?"

CEO John Stumpf: "It's so much easier to sell somebody the sixth product when they already have five with you and you can give them a better deal. Today we have over six products per retail household on average. A third or a fourth of our customers already have eight products or more. And we're still scratching the surface. It seems clear that the financial services industry has a particularly large opportunity to do this."

The following analysis provides statistical validation to the highly successful cross-selling strategy used by Wells Fargo (Figure 4).

This is a correlation analysis of the services we studied in our consumer research on services and fees. This analysis shows that current customers, who are willing to pay for one service, are very likely to pay (buy) additional services from your institution.

A quick refresher course in correlation analysis – the number at the top of each cell represents the correlation (Pearson) coefficient. The closer the number to 1.0, the higher the correlation. These are all very high correlations. The number at the bottom of each cell (.000) is the significance coefficient. The lower the number, the higher the significance. In our case, the significance coefficient between all the variables is .000, which means that the probability of type I error (false positive) in this analysis is less than one tenth of one percent, in other words - 99.9% valid results.

Figure 4 - Correlation analysis of services

Pearson Correlation Sig. (2-tailed)	Pay for personalized couponing	Pay for prepaid cards	Pay for overdraft transfer	Pay for P2P payments	Pay for mobile deposit	Pay for credit score reporting
Pay for prepaid cards	.766					
	.000					
Pay for overdraft transfer	.626	.690				
	.000	.000				
Pay for P2P payments	.708	.717	.719			
	.000	.000	.000			
Pay for mobile deposit	.651	.606	.550	.684		
	.000	.000	.000	.000		
Pay for credit score reporting	.695	.703	.675	.785	.664	
	.000	.000	.000	.000	.000	
Pay for identity theft alerts	.423	.515	.456	.547	.579	.588
	.000	.000	.000	.000	.000	.000

OUTLOOK ON TAXATION AND DEPOSIT BALANCES

An analysis of deposit patterns before and after the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) shows that consumers increased their bank deposits nearly twice as much during the tax cuts period compared with the previous period of relatively higher taxes. Moreover, interest rates on deposits were not a factor in the differing level of balance growth during these two time periods. It seems plausible therefore that the looming expiry of the tax cuts on December 31 is likely to cause a gradual slowdown in the growth rate of bank deposits starting in 2013 and beyond.

Our analysis examined two time periods of nine years each: from June 1992 to June 2001, prior to the enactment of the initial tax cuts measure, and from June 2001 to June 2010, the period following passage of EGTRRA. During the first period, total deposits in FDIC-insured institutions increased by $1.5 trillion, or 42%. However, during the nine years after the tax cut took effect, total deposits increased by $4.1 trillion, or 82%, which is nearly double the rate of growth in the first period (Figure 5).

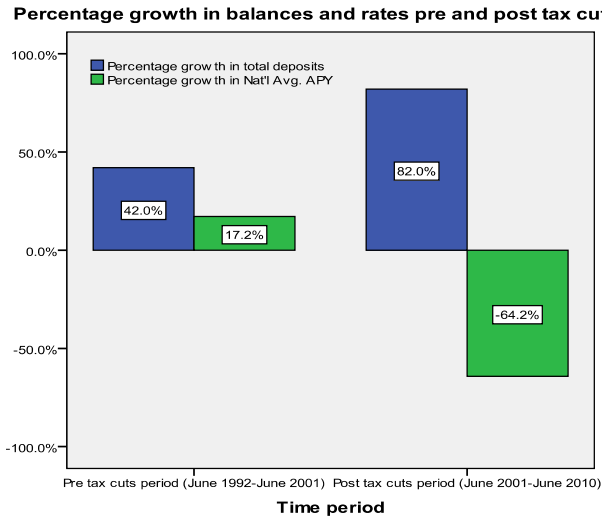
Interest rates on deposits were not a factor in the differing results – quite the contrary, since the change in rates was inverse to the change in deposit balances. During the pre-tax cuts period, when the growth rate of deposit balances was 42%, the national average interest rate on deposits rose from 2.86% to 3.35%, an increase of 49 basis points (bps) or 17.2%. Conversely, during the post-tax cuts period, when the growth rate of deposit balances was almost double at 82%, the national average interest rate on deposits fell from 3.35% to 1.20%, a decrease of 215 bps or 64.2%.

Our analysis also takes into account growth in population and inflation because the data is presented in percentage growth rather than the absolute increase in deposits.

One might reasonably ask whether stock market volatility in the wake of the 2008-2009 financial crisis helped spark the surge into deposits during the post-tax cuts period. An analysis of the monthly volatility of the Dow Jones Industrial Average shows an average change of 1.1% during the pre tax cuts period compared to 0% during the post tax cuts period – not significantly different.

However, it is possible that changing demographics and an increase in the number of retiring baby boomers, who tend do save more conservatively, may have contributed to the growth rate in deposits during the tax-cut era. This segment is likely to increase in the future as well. The Tax Policy Center estimates that an average house-hold income of $75,000 could end up paying about $2,600 more in federal income taxes next year.

Figure 5



CONTROLLING INTEREST EXPENSE WITH TIMELY INFORMATION

In the current declining-rate environment, a lag in reaction to decreases in competitive rates can be costly because you may be paying higher rates for deposits that you could have at a lower cost of funds. The main reason for lagged-pricing reaction is lack of timely information on competitive rate changes. For large deposit portfolios, especially long-term CDs, the additional cost of funds due to lagged-pricing reaction can be substantial.

TYPES OF RE-PRICING PATTERNS

Deposit re-pricing patterns are not uniform among institutions and across different pricing regions. Therefore, your ability to react to competitive rate changes on a timely basis depends on the timeliness of the information you receive. There are two main types of re-pricing patterns (Figure 6):

Floating Week Day

Nationally, 61% of the institutions reprice their deposits in a floating pattern. This means, for example, that one week they may change their rates on a Monday, and the following week on a Wednesday.

Since the day of the rate change is unpredictable, you may have a lag of up to one week with your repricing. For example, if your competitor dropped their rates on a Monday, but you found out only on Friday, you may have overpaid for some deposits for a whole week.

The fluctuation in pricing patterns from one week to the next can be substantial, and can vary by as much as 100% as in the case of Friday in Figure 7.

To find out about competitive-rate changes right away, and prevent unnecessary higher interest expense, you should use Market Rates Insight's Rate Move Alert, which will notify you via email on competitive rate changes in a timely manner. Better yet, this useful information is free to MRI clients.

Figure 6 - Distribution of re-pricing types

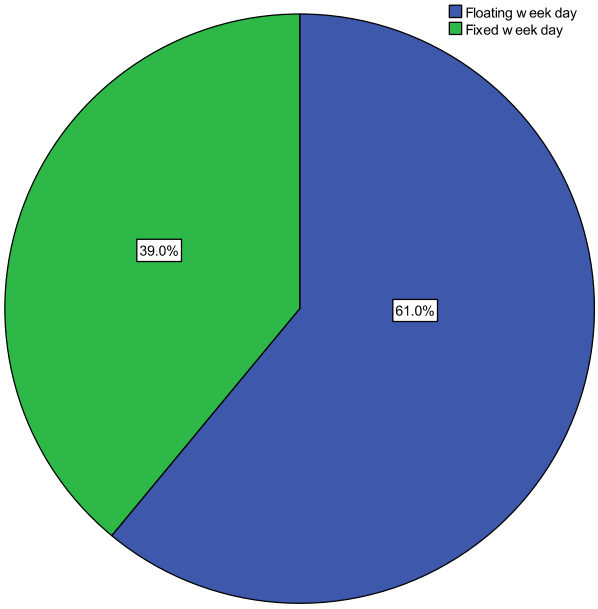
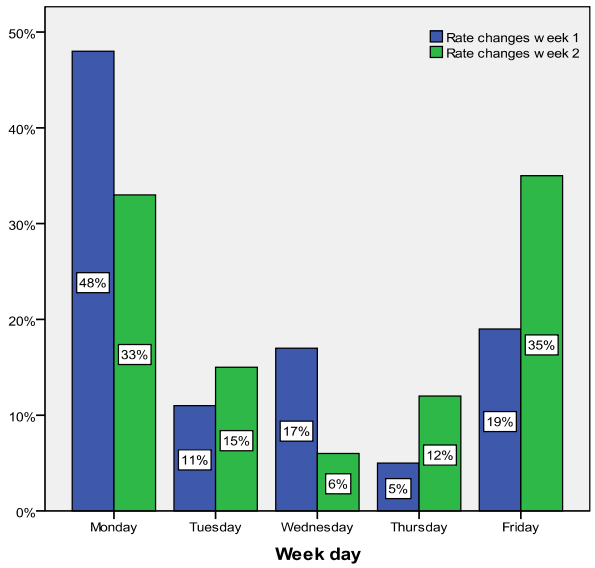


Figure 7 - Fluctuations in re-pricing patterns



TYPES OF RE-PRICING PATTERNS

Fixed Week Day

The remaining 39% (Figure 6) of institutions re-price their deposit products on the same day of the week every week. However, the distribution of rate changes throughout the week descends causing a gradual reduction in the relevancy of the information with every passing day.

Nationally, Monday is the heaviest rate-change day for institutions that re-price on a fixed day of the week, whereas Friday is the lightest (Figure 8). This means that with every passing day of the week, the relevance of your competitive pricing information diminishes to some degree.

For example, if you are using a competitive-pricing report that was produced on Monday for a Friday pricing meeting, you may be missing a substantial number of rate changes that occurred in between. Depending on the re-pricing pattern of your competitors the decrease in relevancy can reach 71% (Figure 9).

If your vendor provides you with reports based on geographic rotation, i.e. East Coast on Monday, South on Tuesday, your information is less relevant with every passing day .

Unlike other survey companies that survey by geography at their convenience, Market Rates Insight surveys all rates "the morning of." This guarantees that rates in the MRI survey are "Effective" up-to-the-moment, and no more than 4 hours old. MRI has a unique capability of mapping the re-pricing patterns and days of all your competitors, advising you when to expect rate changes.

Figure 8 - Percentage of institutions changing rates on fixed days of the week.

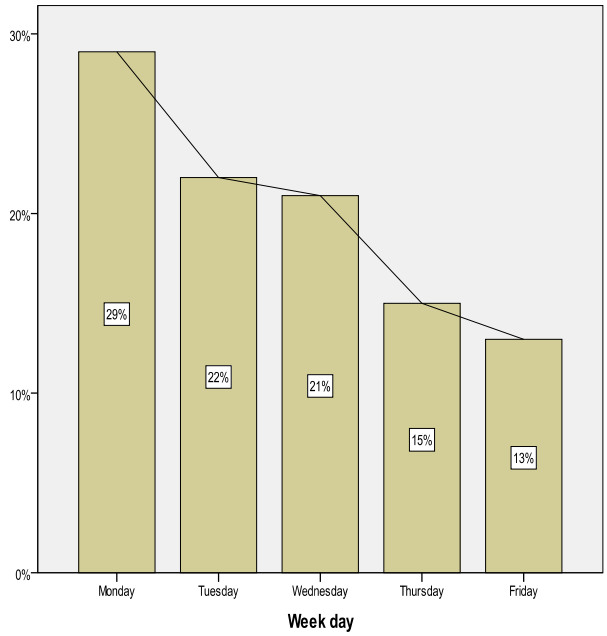
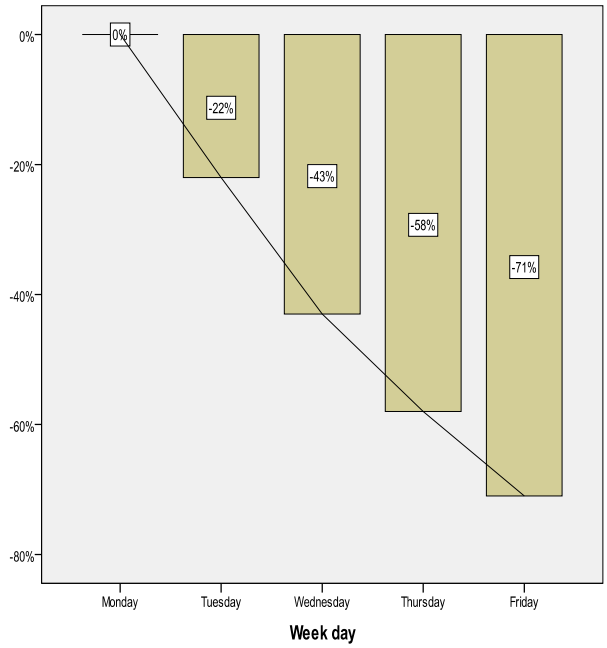


Figure 9 - Daily cumulative percentage decrease in relevancy of competitive data



Contact us to receive 1) Rate Move Alerts of competitive rate changes via email, and 2) map your competitors' pricing patterns for optimal relevancy of your rate information.

PERSPECTIVE ON DEPOSIT RATES SINCE THE RECESSION

The national average interest rate on deposits lost 90% of its yield value in the five years since the start of the recession. In July of 2007, which is the actual start* of the last recession, the national average APY for all deposits stood at 3.28%. As of the end of October of 2012, the national average for deposits is 0.34% - a decline of 90% in yield value (Figure 10), or 2.94% in absolute APY (Figure 11).

The greatest drop in relative percentage occurred with the 3-month CD, which lost 97% of its yield value. The greatest drop in absolute APY occurred in the 12-month CD, which dropped 3.97%. Figures 10 &11 show the relative and absolute change in yield of deposit products in order of liquidity.

Figure 10

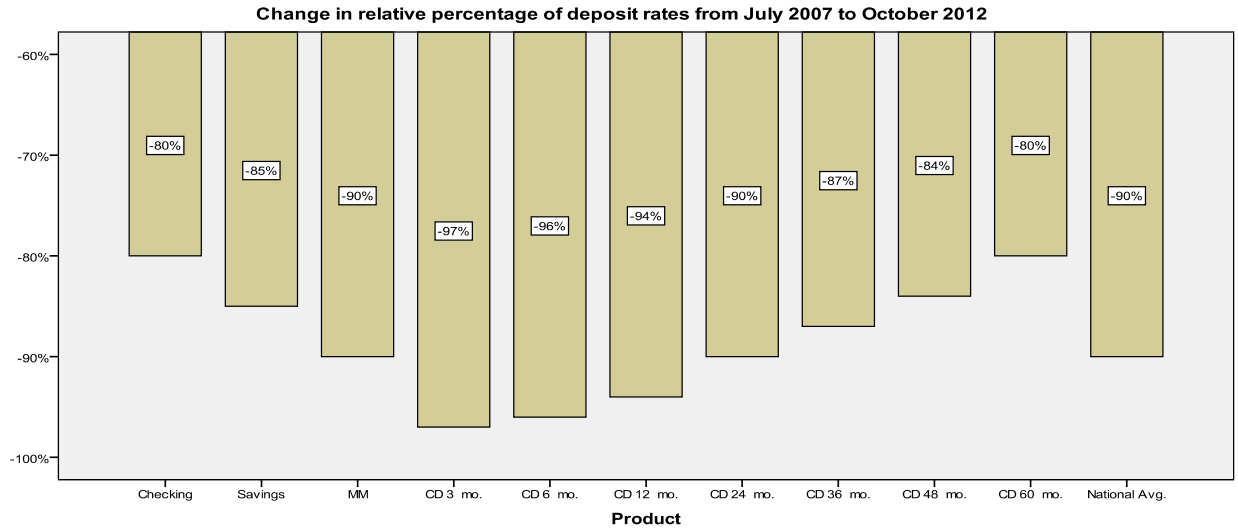
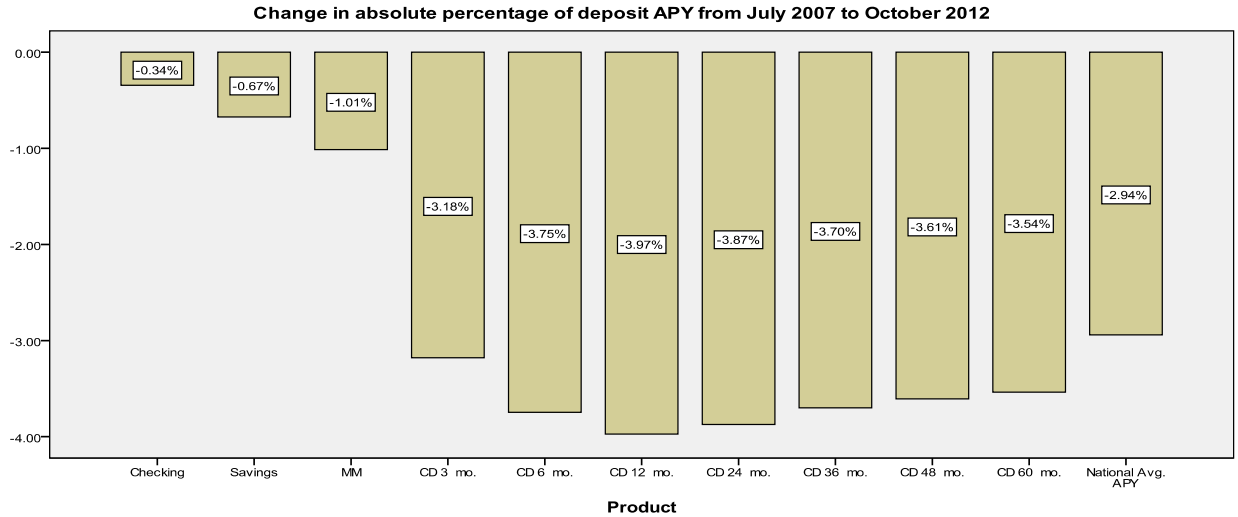


Figure 11



Note: The official start of the last recession was December of 2007, but the actual start was July of 2007 - two consecutive quarters of negative GDP growth prior to the official declaration.

ABOUT MARKET RATES INSIGHT

Market Rates Insight (MRI) is the trusted source for financial information and analysis to financial institutions. MRI's financial data is complete, detailed and timely, which allows for the highest level of pricing decisions and analysis. The use of MRI's financial data ensures more informed decisions, higher level of pricing precision, and above all, an absolute confidence in the validity of the data and analysis.

In addition to providing financial data and analysis to the financial industry, MRI is also a major and trusted source of financial trends and commentary to the media. MRI' reports, analysis and findings are featured and referenced, on a regular basis, in major national, regional and local media channels such as print, TV, and radio. MRI Trend Alerts have been featured on the front-pages of many national publications.

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