THRIVING IN A RISING RATE ENVIRONMENT

Reward checking is your best weapon against interest rate risk and deposit flight.

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SUMMARY

As the economy continues to rebound from the Great Recession and inflation rises with the recovery, U.S. financial institutions are watching interest rates. The FDIC has highlighted interest rate risk as a major concern, given low net interest margins and widespread mismatches between asset and funding maturities.[1] On the consumer side, confidence in the economy has nearly doubled since recession-era lows[2] (see fig. 2), and account holders are now choosing from an array of higher-return options for their dollars. After years of an uncompetitive rate environment that naturally steered consumers to insured deposit accounts over riskier market investments, financial institutions face steeper challenges with retaining their current deposit base as well as acquiring new deposit dollars.

While rates are projected to continue rising (per recent Fed forecast[3]), many institutions remain sensitive even to small increases. Complicating this is the fact that traditional solutions to rising rates, such as certificates of deposit (CDs) or long-term borrowings, mainly provide protection against short-term, rapid rate increases. As a result, they are an expensive and unwieldy solution for the most likely scenario facing financial institutions in the United States.

Our research demonstrates that reward-based checking accounts are an effective weapon against margin compression while enabling institutions to more effectively retain and compete for consumer deposits. The margin benefit of reward accounts may seem counterintuitive at first glance, given their high-yield payouts, but a closer look at their cost structure reveals the advantages:

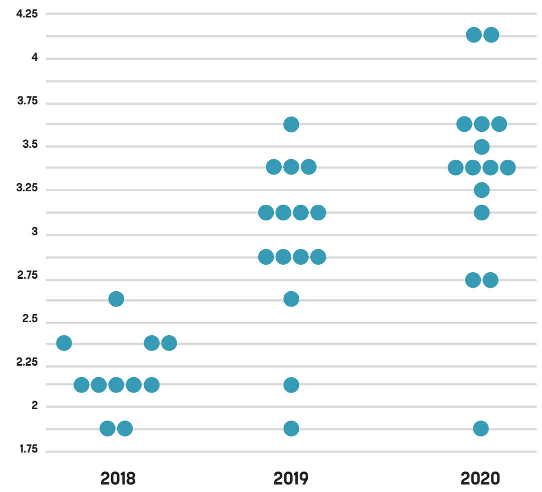
1. The rate environment continues to place reward account rates at a premium in consumers' eyes. Reward checking rates do not need to increase at the same pace as the federal funds rate.

2. Reward accounts are not as costly to financial institutions as they initially appear. Nationwide, reward accounts powered by Kasasa provided a median 56% "discount" on cost of funds (COF) in 2018.[4]

3. As rates rise, the actual dollar value for loaned-out funds increases — along with an institution's COF. In a rising rate environment, the COF discount offered by reward checking accounts is even more valuable compared to conventional deposit accounts.

4. Reward account product designs are highly flexible and can be customized to meet an individual institution's need for funds. For example, reward accounts can be configured to attract large balances or to bring in new account holders without high incremental deposit dollars. Additionally, unlike CDs, reward account rates can be raised or lowered across the account-holder base at any time.

FEDERAL OPEN MARKET COMMITTEE'S PROJECTION OF INTEREST RATES (FIGURE 1)



BACKGROUND

In December 2015, the Fed raised rates for the first time in nearly a decade. Over the next two and a half years, the Federal Open Market Committee passed six additional rate hikes, quickly growing from 0.25% to 2.0% by June 2018.

For consumers, the Great Recession made community banks and credit unions attractive for safeguarding dollars using insured accounts. Consumers shifted from viewing local deposit accounts as investments to using them for money management and preservation. With the economic recovery and a sustained rise in consumer confidence, consumers are now choosing from a range of options with higher returns — including securities and aggressive new deposit rates at national and online banks.[5]

[1] FIL-10-2016, "Interest Rate Risk Videos Updated," February 3, 2016
[2] University of Michigan: Consumer Sentiment [UMCSENT], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/UMCSENT, August 13, 2018.
[3] Federal Reserve Bank of St. Louis and U.S. Federal Open Market Committee, FOMC Summary of Economic Projections for the Fed Funds Rate, Median [FEDTARMD], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FEDTARMD, August 29, 2018.
[4] Data sourced by Kasasa Analytics, utilizing data from nearly 700 community financial institutions with more than 1.8 million high-yield reward checking accounts nationwide.
[5] Back, A. (2018, August 13). "Banks Finally Start to Pay Their Depositors." Wall Street Journal. Retrieved from https://www.wsj.com/articles/banks-finally-start-to-pay-their-depositors-1534152600

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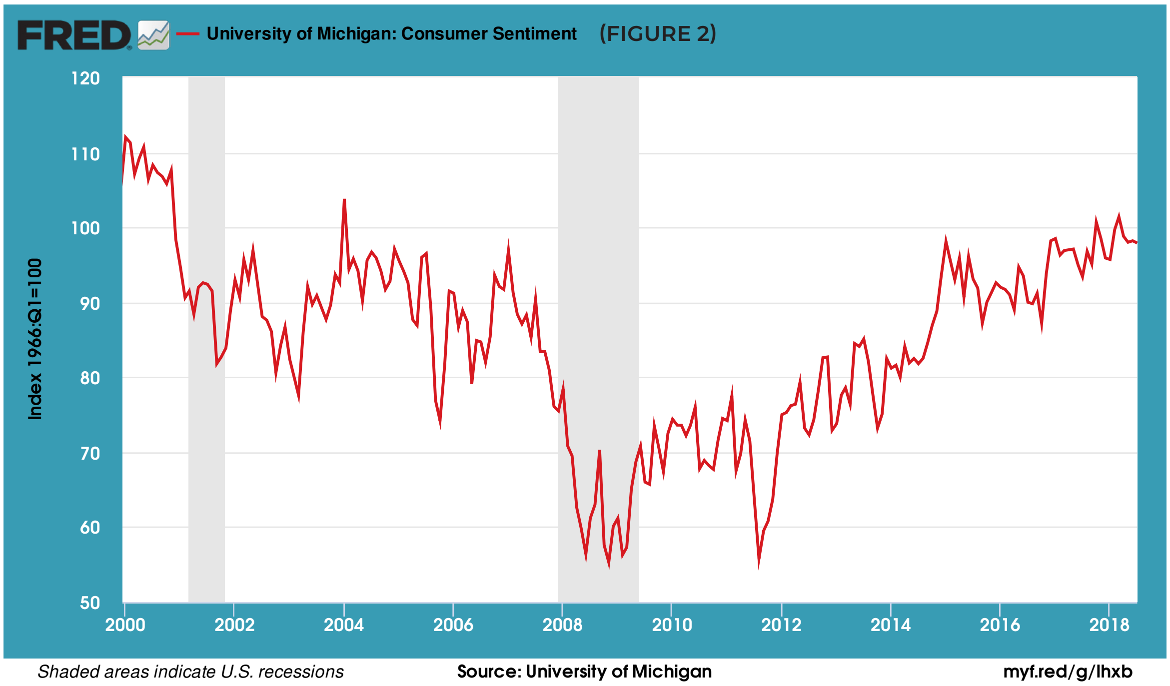

Consumer confidence has risen steadily since 2012.

For CEOs and CFOs at community banks and credit unions, credit risk consumed much of the focus of the past decade. As a result of the Fed's rate moves, institutions are paying more attention to interest rate risk. It can even be argued that financial institution leaders who aren't shifting some focus to interest rates are managing yesterday's risk instead of tomorrow's.

Adding to the complexity, many of the traditional tools used for measuring and managing interest rate risk are inappropriate for today's unique environment. Rate-shock approaches focusing one to two years out may dramatically underestimate the long-term risk of margin compression in a gradual recovery. Furthermore, recent cycles of aggressive mortgage refinancing suggest that those relying on history to calculate the duration of mortgages or mortgage-backed securities may underestimate how long they will operate with very low yields.

These and a dozen other potentially flawed assumptions could lead a community financial institution (CFI) to take the wrong approach to liabilities management — especially with fresh uncertainty regarding the economic and trade outcomes of the current political administration.

Seeking mid-term, rate-sensitive instruments such as certificates of deposit may have worked in other eras, but today's unprecedented circumstances call for growing core deposits. Taking a closer look at the advantages of high-yield reward checking accounts — and their unique COF discount — could be a key strategy to reducing fragility in your deposit portfolio.

May 2004 was the last time exceptionally low short-term interest rates increased dramatically. The yield curve quickly started to flatten, eventually inverting by August 2006.

Diagram A shows a snapshot at year-end 2012 and September 2018, illustrating long-term shifts in the rate environment.

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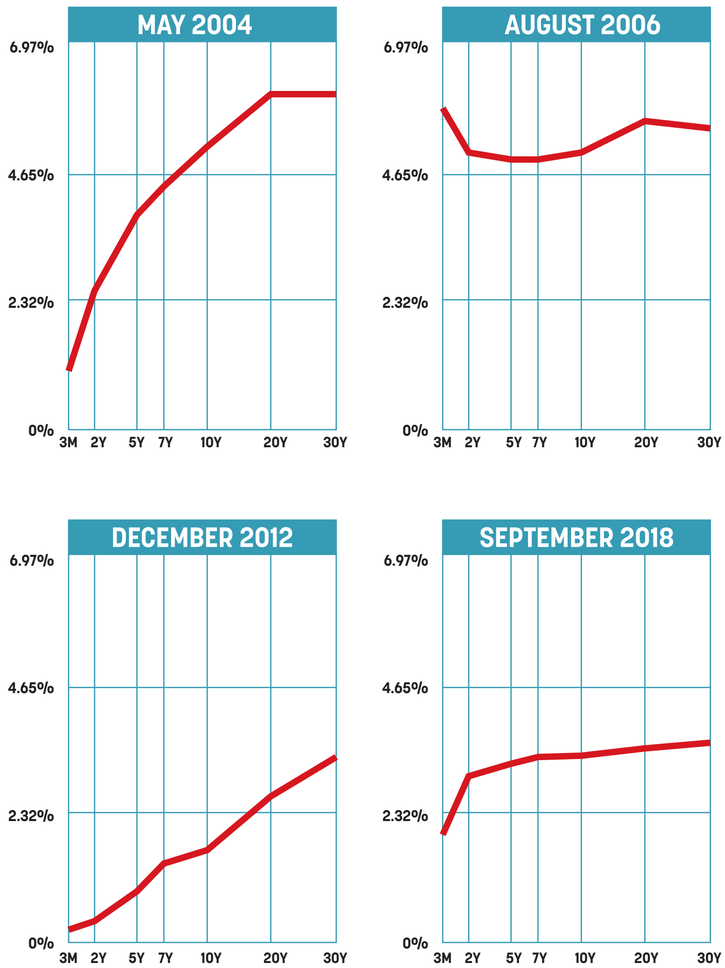
DIAGRAM A



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Here we see a snapshot at December 2012 and September 2018, illustrating changes on the short end of the yield curve and the effects of rising rates.

Source: StockCharts.com

COMPETITIVE RATES WITH MORE GRADUAL INCREASE

High-yield reward checking accounts are priced further out on the yield curve, to entice consumers to move their existing checking account (along with its non-interest income and longevity) and consolidate their long-term CDs. For example, according to Kasasa Analytics, the median promotional rate for high-yield reward checking accounts was 1.99% in August 2018 — compared to the average 60-month CD yield of 1.28% reported by Bankrate.com.

Because reward checking accounts are priced farther out on the yield curve, their promoted rate can rise more gradually than the federal funds rate, lagging behind the yield curve as it shifts upward. This defends against interest rate risk in a rising rate environment, but it also insulates institutions from the liquidity risk associated with instruments like savings and money market accounts — which are priced on the shorter end of the yield curve and highly sensitive to rate volatility and deposit flight.

COST OF FUNDS OUTPERFORMS PROMOTED RATE

High-yield reward accounts typically promote among the highest deposit rates available to consumers. In the current rate environment, the products appear to pay premium rates — making them very attractive to consumers seeking higher returns as consumer confidence recovers. It is important to note, however, that the true cost of funds to an institution is dramatically lower than the promotional rate.

For example, our partner Progressive Savings Bank (a $260MM institution in Tennessee) has had great success offering free Kasasa Cash® checking accounts. In 2018, Progressive Savings advertised a promotional rate of 1.75% APY — but their interest expense for those accounts was only 0.56%. They enjoyed a 68% COF discount versus their promotional rate.[6]

This COF discount occurs for two reasons:

1. Not every account holder qualifies for the promotional rate in a given cycle because they didn't meet the qualification criteria. These account holders are paid a nominal "base rate," typically 0.05%.
2. Account holders who do qualify are paid the highest promotional rate only on balances up to a predetermined balance cap. Dollars above that cap receive a lower interest rate, reducing the account's overall interest expense relative to the promoted rate.

Progressive Savings set their balance cap at $15,000. When a qualifying account holder's balance exceeded this amount, the first $15,000 earned the promotional 1.75% APY and the dollars above $15,000 earned 0.05% APY. Even when an account holder qualified, a balance of $25,000 earned a blended APY of 1.25%. The larger the balance, the lower the actual APY paid becomes.

COF DISCOUNT INCREASES AS RATES RISE

Because of our nationwide network of partnerships, Kasasa has access to analytics for more than 1.8 million reward checking account holders at nearly 700 CFIs. This data demonstrates that the cost of funds discount enjoyed by Progressive Savings Bank is shared by community financial institutions nationwide. **Of Kasasa reward checking accounts at those institutions, the median promotional rate was 1.99% in 2018, but the median COF was 0.88% — a COF discount of 56%, or 111 basis points.**[6]

Reward checking accounts are the only major deposit products that enjoy this significant COF discount, an advantage that is often overlooked. Even more noteworthy, this advantage increases as rates rise. Reward accounts already pay rates that consumers perceive as premium, and the inherent advantages of these accounts allow CFIs to price promotional rates further out on the yield curve.

Assuming an institution keeps the same promotional rate and balance cap, and those account holders qualify at the same rate, simple math demonstrates reward checking's growing advantage as rates rise. A 56% COF discount on 4.00% APY would equate to 1.76% COF, a discount of 224 basis points. In comparison, a 3.67% APY CD (the average 5-year CD rate prior to 2008's economic collapse) carries a COF of exactly 3.67%. Since competing products like CDs and money markets enjoy no discount, the COF savings with a reward checking account offers a formidable funding advantage in an economic environment where rates are rising.

EASILY CUSTOMIZABLE TO FUNDING NEEDS

In addition to the organic discount between the promoted rate and cost of funds, reward accounts benefit from proactive performance analysis and product design adjustments. A slight change in product design can easily translate to a 0.5% or more decrease in actual cost of funds for that product. These savings can add up quickly with a product that typically has average balances four to five times greater than free checking. This versatility makes reward accounts easily customizable and highly capable of meeting individual institutions' unique funding needs.

A MAJOR COMPETITIVE ADVANTAGE

A CFI with a deposit mix that includes a sizeable reward checking base has a major competitive advantage over those that do not. The COF discount and significant non-interest income associated with reward accounts enable community financial institutions to price their accounts farther out on the yield curve, retaining current deposits or attracting new deposits that would otherwise go elsewhere. Furthermore, Diagram B illustrates how reward checking combats interest rate risk by reducing the margin compression of more traditional deposit products as rates go up.

A focus on short-term risk mitigation can lead to the belief that CDs will help mitigate longer-term interest rate risk, but

[6] Kasasa Analytics.

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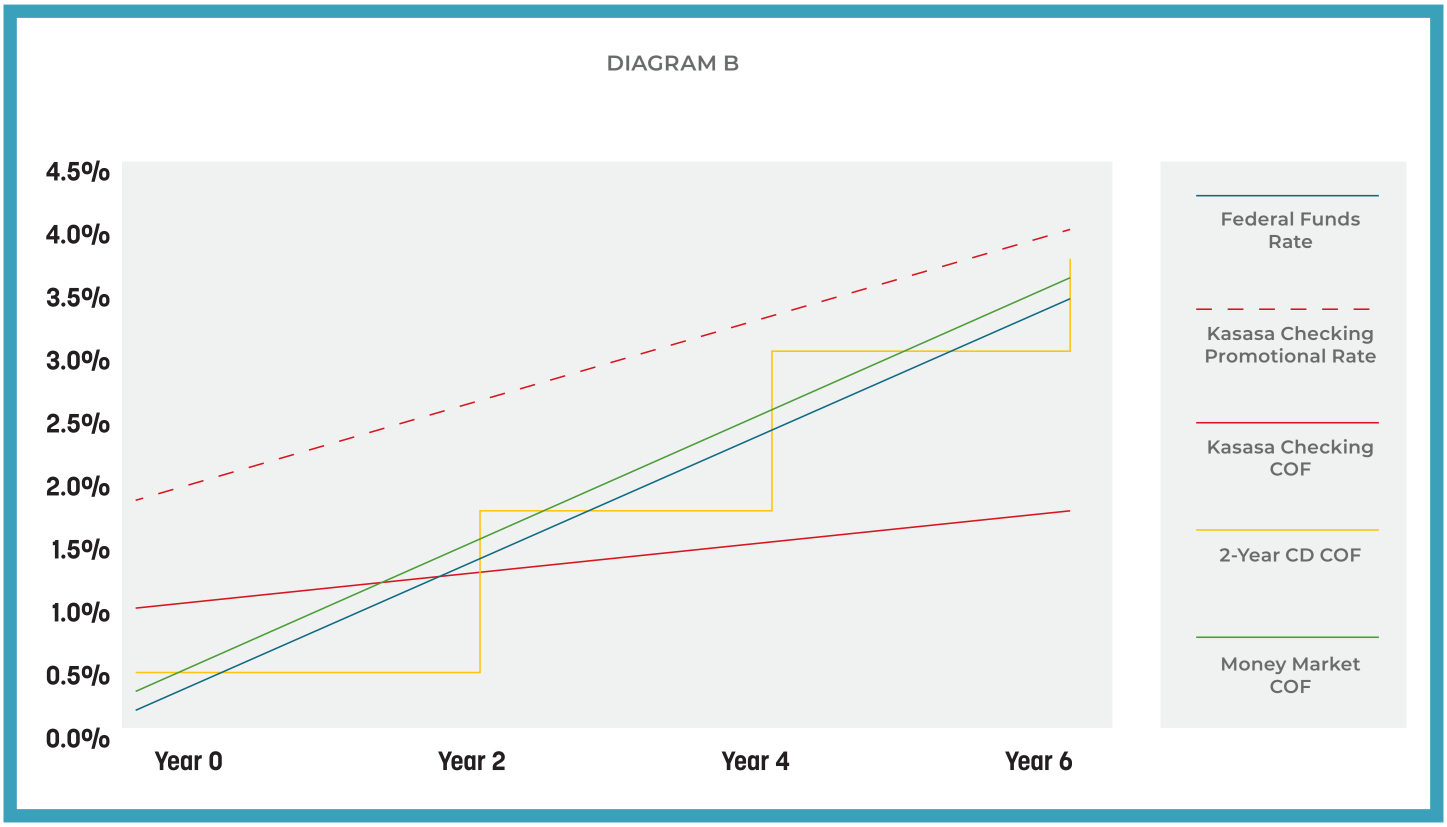
comparative modeling shows that this is not the most advantageous approach. Diagram B demonstrates how, as rates rise steadily over a period of time, the 2-year CD rate eventually rises as well, with a sharp jump once it reprices.



This graph illustrates the cost of funds of an individual CD as it re-prices. If we were to plot a CD deposit mix as a whole (accounting for new CDs opened each month) the picture would look even worse for CDs, with the yellow line above the blue line for even more of the duration. In contrast, the reward checking COF not only combats margin compression — it even improves the institution's interest margin as rates rise over an extended period, since the COF discount grows with the overall rate environment. A reward checking portfolio may re-price more quickly than CDs,but in the long run it will actually result in widening margins as rates rise.

This chart uses a hypothesized rate trend, but it demonstrates the effects we can expect. It starts with rate data at the end of 2013, and the various products are plotted over time as they typically react to the federal funds rate. These relationships will generally hold true whether the yield curve rises or flattens. Regardless of your particular appetite for credit risk or ability to deploy funds into assets, any COF below the federal funds rate represents a return that is essentially risk-free (through a lower interest rate paid on accounts than earned on overnight loans to other institutions). This added income operates as yet another hedge against interest rate risk.

MAXIMIZING YOUR DEPOSIT MIX

While many CFIs already have a reward checking program in place, the majority do not. The good news is these CFIs can benefit even if they launch such a program in the midst of a rising rate environment. This is because such programs, when deployed correctly, can have an immediate impact on your deposit mix.

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Before Bank of Weston (a $120MM community bank in Missouri) launched with Kasasa, they reported the following deposit mix: 55% CDs, 25% savings and money markets, and 20% checking accounts. When they launched Kasasa Cash their deposit portfolio quickly started improving. Two years later, their deposit mix was 20% CDs, 20% savings and money markets, and 60% checking.[7] Bank of Weston realized this success without substantially increasing their overall deposit dollars. Ocean Communities FCU (a $150MM credit union in Maine) experienced similar results, shifting their deposit mix from 54% CDs prior to launching Kasasa Cash to 26% afterward.

These institutions quickly expanded their access to the interest rate advantage of reward checking accounts. As a bonus, they also shifted their deposit concentration from rate-sensitive CD holders to the core deposits of more loyal, engaged reward checking account holders.

CONCLUSION

When examined closely, reward checking accounts prove to be a stable, long-term defense against interest rate risk, effectively hedging against margin compression. This is a result of a few advantages:

1. The promoted rates are priced at a premium in the current rate environment and will not rise as quickly as the rate of other products. They insulate CFIs against interest rate risk as well as the liquidity risk associated with shorter-term instruments.
2. Nationwide reward accounts provided a median 56% “discount” on cost of funds in 2018 compared to the promoted rate.[9]
3. The actual dollar value for loaned-out funds increases as rates rise, but so does overall COF, which makes reward checking accounts’ inherent COF discount even more attractive in the event of sustained rate increases or other market volatility.
4. Reward account product designs can be customized to meet financial institutions’ unique needs for funds and are a much more flexible funding source than CDs.

In addition to these manifold economic advantages, the premium rates of reward checking accounts enable institutions to retain current deposits or compete for new deposits that would otherwise move elsewhere as interest rates rise.

Banks and credit unions with a deposit mix that favors high-yield reward checking over traditional funding instruments like CDs have a long-term competitive advantage over those without. As rates rise, these financial institutions will benefit from stronger non-interest income, greater operational flexibility, broader consumer appeal, and interest margins that widen versus peers that are dependent on funding sources more sensitive to interest rate risk.

[7] Courtesy Bank of Weston.
[8] Courtesy Ocean Communities Federal Credit Union.
[9] Kasasa Analytics.