Higher Deposit Rates – Where Art Thou?

Abstract

Bank deposits have not benefitted from recent fed funds rate increases. The absence of higher rates contrasts sharply with the yields on marketable securities and compares unfavorably with deposit rates seen in two previous Fed tightening cycles. Although prospects for higher deposit rates may improve soon, for now, liquidity investors should consider a portfolio approach that includes deposits and direct purchases, possibly through separately managed accounts.

Introduction

Deposit relationships provide essential liquidity solutions for most treasury organizations. Several of our recent whitepapers have discussed the transformation of corporate deposits following significant regulatory changes in the banking and money market fund industries. Recent Federal Reserve data and industry surveys continue to support the popularity of deposits among institutional investors.

On the other hand, depositors have not yet seemed to benefit from the Federal Reserve’s recent interest rate actions. While the yield on short-term marketable securities such as commercial paper (CP), has risen in tandem with the fed funds rate’s 1.00% increase since December 2015, deposit rates have not kept pace. Understanding how and why deposits lag behind market rates helps us to appreciate the opportunity costs associated with bank deposits.

In this paper, we will compare deposit rates in the current interest rate environment with those of two previous Fed tightening cycles to demonstrate that, while deposits generally lag the market when rates are rising, this lagging effect is more pronounced today than in the past. We will discuss potential causes for this phenomenon and the potential timeframe for improvement in deposit rates. We will also offer our take on how institutional investors can best utilize deposits along with other short-term liquidity instruments in a portfolio approach.

Corporations Have Strong Preference for Deposits

Bank accounts have been a main liquidity tool for as long as modern banking has existed. Beginning in the late 1990s, however, their popularity declined as investment in money market funds (MMFs) surged. This trend continued until the financial crisis of 2008 forced investors to reassess the latter’s resilience as stable liquidity vehicles during market tumults. Since then, as the Federal Reserve’s Flow of Funds report (Figure 1) indicates, the combined savings and checking account balances have consistently accounted for nearly three quarters of the liquid balances at non-financial firms in the United States.
Survey results from institutional liquidity investors confirm deposits’ popularity. A 2017 liquidity survey of 683 institutional investors by the Association for Financial Professionals found that 59% of the organizations’ short-term portfolios are allocated to bank deposits and Eurodollar deposits (Figure 2).

Figure 2: Short-term Portfolio Allocations (%) by 2017 AFP Survey Respondents

Source: 2017 AFP Liquidity Survey: Report of Survey Results, Page 10
The 2016 MMF reform that requires prime institutional funds to float their net asset values (NAVs) and impose redemption fees and gates in times of stress also seems to have encouraged more cash to flow into deposits. While some participants believe that the reform merely resulted in the reshuffling of fund assets between prime and government funds, the Fed’s Flow of Funds reports (Figure 3) tells a different story.

**Figure 3: Changes in Liquid Instruments at Non-Financial Firms**

![Graph showing changes in liquid instruments at non-financial firms](source: Federal Reserve Board, Financial assets of the United States 1970-2016, L102)

Between the 4th quarter of 2015 and the 1st quarter of 2017, the latest period for which data is available, MMFs collectively lost $91 billion (14%) in assets. Mutual fund shares, which include ultra-short bond funds, gained $11 billion (5%). Deposits, by contrast, grew by $409 billion (20%).

We derive from Figure 3 that an important outcome of the 2016 MMF reform may be that new cash from strong corporate profits and other sources that would have previously gone into MMFs has instead found a home in bank deposits.

It is safe to assume that institutional liquidity investors’ preference for deposits in recent years have not been driven by attractive yield opportunities as a sizeable portion of the cash has been in non-interest bearing transactional accounts. Also, banks have not been generous in handing out higher yield as the Fed continues with interest rate normalization.

**Banks Are Not Keeping Pace with the Fed on Yield Increases**

From December 2015 through June 2017, the Federal Reserve has raised the short-term rates four times at 0.25% increments. Short-term market rates have climbed in response, but bank rates have yet to see meaningful increases.

Figure 4 provides a snapshot of short-term rates over the last two years. The top range of the fed funds rate (FFR) rose from 0.25% to 1.25% while the 30-day A1/P1-rated commercial paper (30DCP) index rate rose from 0.16% to 1.20%, closely matching Fed’s rate increases.

By contrast, national average deposit rates published by the FDIC have hardly budged. Among jumbo deposits (greater than $100,000), the money market rate (MMR) has risen only 0.01% to 0.12% since December 2015. Over the same period, the one-month certificate of deposit rate (1MCD) stood unchanged at 0.07% and the three-month CD rate (3MCD) rose only 0.02% to 0.11%.
A comparison to the two previous Fed tightening cycles (June 1999–May 2000 and June 2004–June 2006) indicates that banks today are comparatively less willing to pay up on deposits.

Source: FDIC’s weekly national rates and Bloomberg

**Figure 4: Comparative Short-term Interest Rates**

Source: Bankrate.com and Bloomberg

**Figure 5: Changes in Select Short-term Interest Rates**

Source: Bankrate.com and Bloomberg
Figures 5 and 6 provide the changes in select short-term rates alongside the FFR in the three rate hike cycles, from three months before the first hike to three months after the last one. Due to the lack of historical data on FDIC national average rates, we used Bankrate.com’s respective indices.

Figure 5 shows changes for three deposit rates (MMA, 1MCD and 3MCD), and two market-based rates (1DREPO and 30DCP). Figure 6 shows their changes relative to the changes in the FFR.

- **03/99-08/00**: Figure 6 shows that MMA was the best performing instrument during this cycle, rising 113% relative to FFR increases, followed by 30DCP, which rose by 94% of FFR increases. Overnight repo and 3MCD rose 82% and 62%, respectively, of FFR increases.

- **03/04-09/06**: In this period, 30DCP was the best performer, matching (+100%) FFR increases, followed by 1DREPO, which rose 96% of FFR increases. 3MCD, MMA and 1MCD rose 75%, 45% and 25% of FFR, respectively.

- **09/15-06/17**: In the current period, 1DREPO rose 108% of FFR increases, followed by 30DCP which rose 103% of FFR. 3MCD, MMA, and 1MCD have hardly moved, rising 6%, 4% and 2% of FFR, respectively.

To conclude, despite the 1.00% total increase in the fed funds over the last 19 months, money market and short-term CD rates barely budged. Historically, these rates tended to rise with the fed funds rate, sometimes exceeding the benchmark rate increases. By contrast, short-term market rates rose along with FFR in all three periods by about the same magnitude.

**Possible Causes for Low Deposit Rates**

What has contributed to the low deposit rates seen in the current cycle? We can think of several possible causes, most of which trace back to the aftermath of the 2008 financial crisis:

- **Abundant bank reserves**: The Federal Reserve implemented several rounds of asset purchases to prevent the economy from collapsing following the financial crisis. Its growing balance sheet also resulted in a huge
increase in bank reserves which grew from just over $8 billion at the end of 2007 to a peak of $2.8 trillion in late 2014. Currently at $2.2 trillion (as of 6/30/17), these abundant reserves provide sufficient liquidity in the banking system and this lessens the need for banks to pay higher rates on deposits.

**Restrictive banking regulations:** Financial regulations implemented since the financial crisis resulted in higher capital adequacy and balance sheet liquidity requirements. Banks need to optimize the use of deposits for high margin lending and capital markets activities to justify the costs of holding deposits on their balance sheets.

**Banks keeping the first cut:** Banks have typically held on to the fruit of early rate increases. After nearly a decade of compressing net interest margins (NIMs), or spreads between lending and deposit rates, banks appear to be paying themselves before awarding depositors.

**Investor inertia after a long period of yield drought:** After enduring nearly a decade of zero interest rates, some depositors may not have adjusted their expectations for higher income returns as the first few Fed hikes have occurred. They may become more demanding now that short-term benchmark rates are greater than 1.00%.

**MMF reform:** In past cycles, yield on MMFs tended to trend higher with fed funds, which would in turn led to some asset migration from bank deposits. To fight off competition, banks would typically offer higher rates in order to retain depositors. The 2016 MMF reforms has greatly reduced institutional cash investors’ appetite for prime funds and the absence of competition from prime funds has allowed the banks to keep returns low despite rate increases.

**Reasons to Hope for Higher Rates**

Are higher deposit rates in sight? Are banks simply delaying an increase or will they pay below-market rates on deposits permanently? Do some depositors receive preferential treatments over others? These are a few questions that lack clear answers.

Based on information that we have obtained from banking executives and investors, we expect banks to begin to raise deposit rates, although the increases are likely to remain less competitive than market rates until reserves are drained and lending picks up substantially. As the market adjusts, depositors may receive differential treatment based on the size and types of their deposits.

**Improved bank profitability:** With recent fed funds rate increases, bank NIMs have largely reversed course and they are on the path to stronger profitability. Improving prospects resulting from of lower taxes, higher government spending and financial deregulation also may further benefit bank profitability and banks may be more willing to share some rewards with depositors. Stronger economic growth could also spur stronger loan demand, leading to higher demand for deposits.

**Regulatory considerations:** One item of financial regulation that makes corporate and retail deposits attractive to banks is the liquidity coverage ratio (LCR) requirement, which requires large and moderate sized banks to maintain stable sources of funding. The rule requires banks to maintain an adjusted short-term assets-to-deposits ratio of at least 100%. Compared to deposits from financial institutions, retail and corporate deposits are considered by law to be more stable and are assigned conversion factors which make it easier for a bank to pass the LCR test. The full compliance date of the rule was January 1, 2017, which has made these deposits more attractive for banks.

**Earnings credit rates and Regulation Q:** Banks have not been aggressive in raising rates partially because they compensate institutional depositors through earnings credit rates (ECRs) within non-interest bearing accounts. ECRs are akin to soft-dollar arrangements that help institutions offset banking fees. As interest rates rise, ECRs start
to lose their appeal as depositors demand hard-dollar income beyond soft-dollar fee rebates. Regulation Q, a Depression Era banking law that prohibited banks from paying interest on business checking accounts, was repealed in 2010 by the Dodd-Frank Act. Institutional depositors may finally benefit from the repeal and start receiving interest on their checking accounts.

Not all deposits are the same: We acknowledge that, while the national averages from the FDIC and Bankrate.com barely budged, some institutional depositors may receive preferential unpublished deposit rates greater than these averages. During recent earnings calls, senior bank executives admitted that they are paying competitive rates to some of their larger institutional depositors. “It is a tale of two cities,” noted JPMorgan Chase’s Chief Financial Officer Marianne Lake to investors on July 18, 2017. Data regarding the rates that banks pay to its preferred depositors remains unavailable to the greater liquidity management community.

Uninsured Deposits Involve Credit Risk
While on the subject of returns, one cannot overlook the fact that deposits above the $250,000 FDIC limit are unsecured loans to the borrowing bank. Many, if not most, institutional cash management accounts fall into this category. Relative to safety and liquidity, yield potential generally ranks a distant third objective among such investors.

SIB resolution: The FDIC has the authority to resolve failing systemically important banks (SIBs), forcing some creditors to shoulder the losses before depositors. Uninsured deposits are paid out after insured deposits, and institutional depositors are paid after retail depositors. Since 2016, foreign banks with at least $50 billion in assets in the U.S. fall under the same rule as U.S. banks through an intermediate holding company structure.

Asset risk: Seemingly healthy bank balance sheets in the US may face tough tests in the days ahead. Adverse credit issues are developing in energy company loans, subprime auto loans and leases, credit card and student debt, commercial real estate and in other areas. Higher interest rates are a double-edged sword, as they help to boost bank profits but also reduce borrowers’ ability to make loan payments. Credit concerns exist disproportionately at smaller non-SIBs, making diversification of deposits among banks more challenging.

Risks from global markets: Banks with large investment banking or credit exposures to overseas markets suffering from a stronger dollar may experience credit issues. Many are scrambling to cope with Britain’s exit from the European Union. Economic and geopolitical risks may also occur in Europe, Asia, and Russia, along with policy uncertainties under the Trump administration.

Mindset Change: The expectation that regulators will fix failed banks is no longer relevant in the current regulatory environment. New tools, such as intermediate holding companies and living wills, allow regulators to fix parts of a failing bank and let other parts fail, presenting new challenges to bank creditors. Recent examples of how the European Central Bank dealt with failing banks in Spain and Italy remind us that credit losses to bank creditors can be severe.

Conclusion – Address Risk and Returns in a Portfolio Approach
Deposit accounts as an original liquidity tool will continue to be important for institutional liquidity management. But as recent data supports, depositors have not yet benefitted from a higher fed funds rate. While rates are poised to rise at some point, depositors may be at a disadvantage compared to investors in short-term marketable instruments which respond more quickly to higher policy rates.

We think that a portfolio approach that combines deposit products with direct purchases of marketable instruments may deliver more optimum risk and return benefits.
A) Deepen Existing Relationships: For regulatory reasons, banks prefer retail and corporate deposits over financial institutions. They also tend to be more willing to pay higher rates to depositors with other banking relationships. Consolidating banking services with a smaller number of banks may improve the prospect of higher deposit rates.

B) Diversify: It may seem contradictory to the first point, but diversification remains important for business as well as counterparty credit reasons. It pays to keep relationships at a few strong banks that suit the depositor’s needs rather than putting all the eggs in one basket. Banks have different costs structures and objectives which may result in different and shifting policies and incentives.

C) Beware of Higher Rates: Depositors should be cautious of banks that pay rates substantially above market levels, as they may be a sign that such banks are having difficulty receiving funding or are simply growing too quickly. This selection process will require more scrutiny of counterparty credit assessment.

D) Embrace Marketable Instruments: As demonstrated in Figures 4 through 6, deposit rates tend to lag marketable instruments even when banks do eventually start to pay up. Repurchase agreements, agency discount notes, commercial paper and short-duration corporate notes tend to reflect higher interest rates more quickly. A portfolio of such instruments with conservative maturities may realize market yield potential and at the same time diversify risk away from single bank exposures.

E) SMAs with Credit Oversight: In the same vein as the direct purchase of marketable securities, institutional investors with resource constraints may wish to consider separately managed accounts (SMAs) through an outside asset manager. Experienced managers may also have additional resources to help monitor and manage investors’ overall counterparty risk exposures.
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