

WHITE PAPER



Relevant Deposit Growth Trends

Approaches to Countering an Absolute Decline in DDA and Other Low-Cost Balances

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Uncovering the Real Story on Deposit Accounts

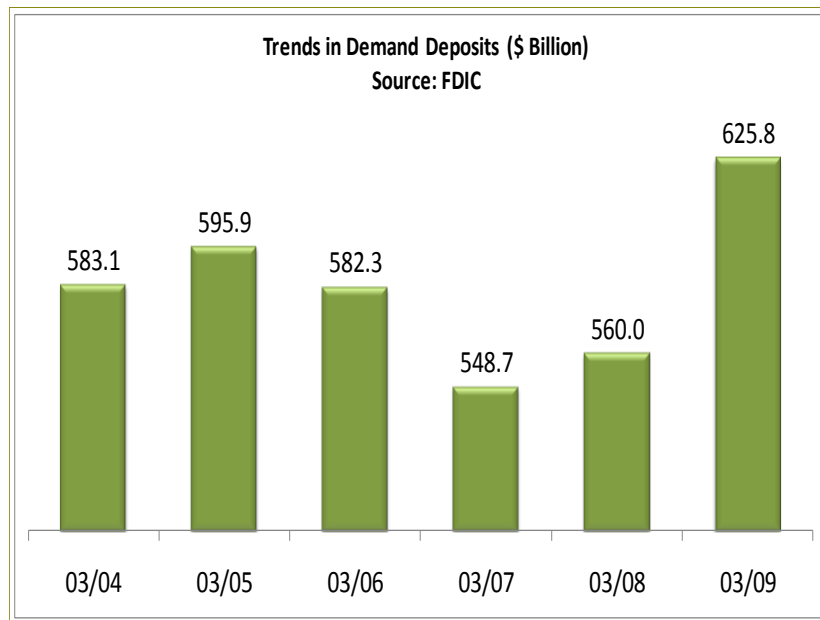
While total deposits continue to grow, it is the distribution of deposit account types that creates the real problem for bankers, vis-à-vis the cost of funds. Proof of the magnitude of the challenge facing banks to contain their funding costs is provided by a review of:

- The long-term trend in the absolute level of DDA balances
- The other relatively lower interest cost transaction account balances

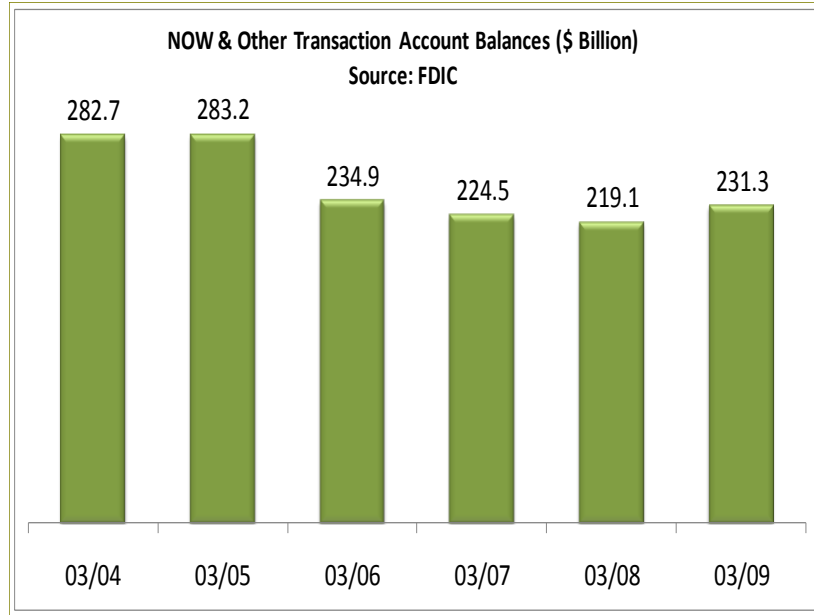
The data in the two graphics below cover the last six years and reflect aggregate balances as reported weekly by the Federal Reserve System. These data depict the monthly average balances for March 2004 through March 2009.

We are not looking at just a relative decline in DDA balances compared to other deposit types or as a percentage of assets (though that is happening too), but at an absolute decline in the level of checking account balances. These trends would be even worse if adjustments were made to include the impact of inflation on these data.

The spike in March 2009 likely reflects the movement of assets from securities, bonds and money market funds back to the comparatively safe haven of commercial banking in the wake of the market downturn. It is an exception that illustrates the unfavorable general trend in “free” deposit balances. There is no particular reason to think that the overall trend will permanently change, but the crystal ball is very unclear about the life expectancy of this phenomenon.



For all the investments in transaction services designed to attract DDA balances, individuals, corporations and public entities have found other accounts (all interest-bearing) and other vehicles from which to conduct their funds transfers and complete their payments.



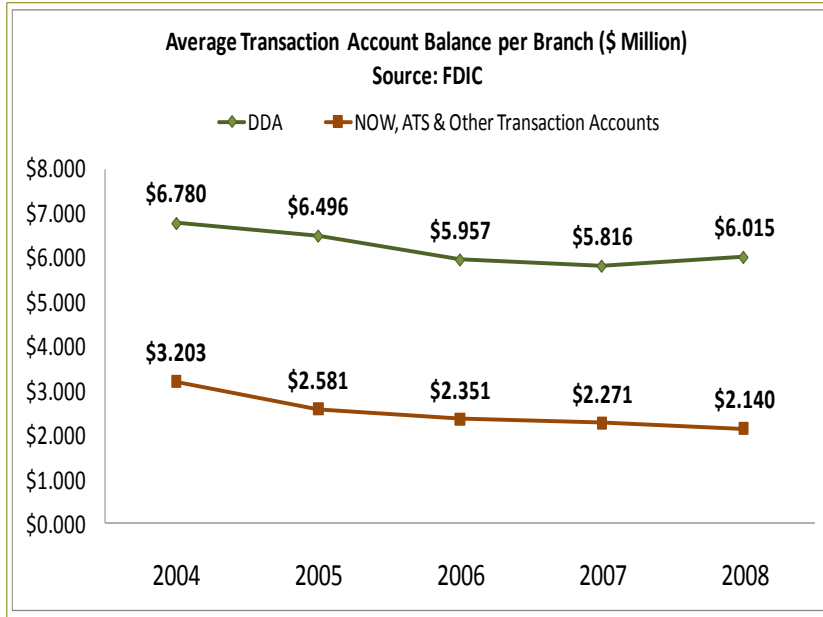
Bankers have frequently abetted this movement with an ever-widening array of sweep products (which they buy back as more expensive repurchase agreements) and interest-bearing transaction balance types (high-interest “loyalty” accounts being the most current example). These actions were taken in the name of earning fee income and capturing deposits (regardless of their cost). The net effect created a stagnant level of other transaction balances over the past six years.

Domestically, approximately 8,000 plus banks have been pursuing around \$320 billion in DDA balances over the last five years. The prospect that most of these banks can effectively differentiate themselves as providers of cost-effective, more-attractive deposit services is simply not good.

The net result of this activity (with the caveat that these data end before the March 2009 spike in DDA balances) is a consistent pattern of declines in DDA balances as a funding vehicle for bank assets.

Questioning Channel Investments

With the relative overall decline in DDA balances, bank executives must ask themselves if investments in branches and alternative transaction service channels are yielding reasonable results.



While total deposit balances have grown by nearly 29% over the past five years according to the FDIC, total DDA balances have declined by more than 11% in the same timeframe.

The number of domestic bank offices grew by about 8% between 2004 and 2008, at the same time that DDA balances were declining. As a result, average DDA balances per branch declined by nearly 13% in the five year period.

Other transaction account balances also have declined in this period, as noted in the graphic on the left.

Internet-only banks such as ING and HSBC have demonstrated that time deposits can be collected cost effectively (without branch systems and where technologies such as remote check capture and mobile banking are increasingly popular). One obvious implication is that branching may finally have reached a point where it is time to question again the utility of this costly delivery structure.

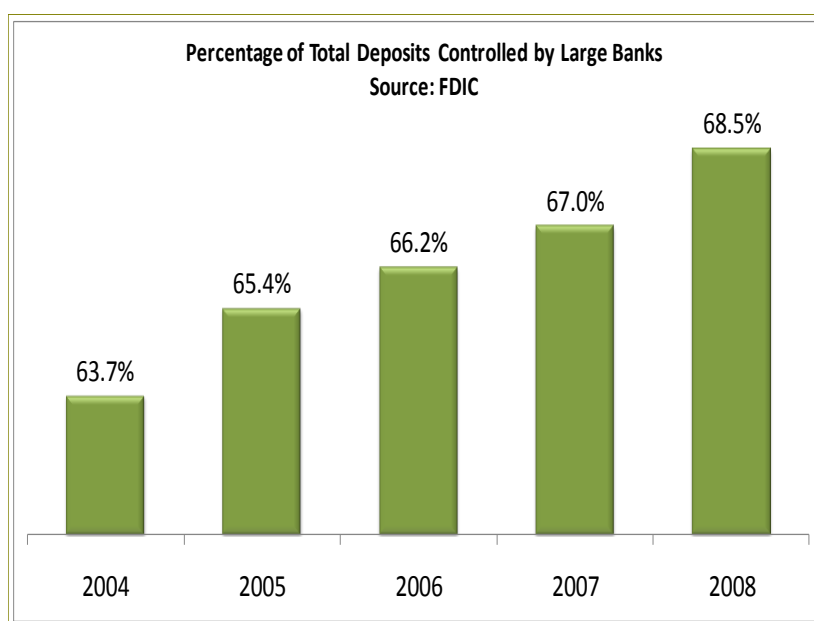
The continued ascendancy of the debit card and the emergence of other transaction devices, including mobile banking, only spread the ever-increasing cost of servicing transaction accounts across smaller outstanding balances. These costs are layered on expanding branch costs, fixed ATM expenses (despite declining usage patterns) and slowly declining check processing expense – which turns out to include a good deal on fixed expense. At some point, the all-in cost of these supposedly low-cost balances will actually outstrip the mostly interest-only cost of non-transaction account certificates of deposits.

Increasing Concentration Pressuring Most Banks

Compounding the challenge for many smaller banks is the distribution of deposits within this country. In 2008, just 116 of the nearly 8,400 banks in the United States (with assets of \$10 billion or greater) controlled nearly seven of ten deposit dollars (68.5%) nationally. This is an increase of about 8% in deposit share in just five years.



Countering this trend requires better focus by senior managers and marketing and product specialists as they work to remain competitive in a market dominated by relatively few large banks. Most banks would do well to remember that the competition is the largest banks, not the small bank down the street cutting prices and engaging



in other irrational marketing gimmicks in the hope of out pointing other small banks. The relevant competition is not other regional banks – it is the segment of banks that increasingly control the market for deposit services. The question becomes: What actions can bankers execute to capture their fair share of DDA deposits? The following section of the paper will present both short- and long-term approaches to this formidable challenge.

Approaches to Addressing Deposit Growth Challenges

Immediate actions bankers can take to address growing core deposits include the following:

Form an objective analysis and a clear strategy

First and foremost, every bank must understand the operating cost implications of continued investments in capturing and servicing a shrinking transaction account balance pool. The basic fact is that as a reliable, low-cost source of funding, transaction accounts have diminishing value.

Bankers must accept the fact that resources committed to compete for and retain DDA and other transaction accounts may be better used for other purposes, if the sole reason for the pursuit of transaction accounts is low-cost balances.

This is particularly important in the present environment in which capital investments and operating expense commitments are being made in pursuit of low-cost transaction account balances. It does not take a cynic to conclude that the same benefits are frequently claimed for many different initiatives. This leads one to question the validity of many investment business cases produced by product managers attempting to reach what may well be an unreachable objective.



Banks should abandon pursuit of transaction accounts altogether, especially if their objective is fees rather than balances. Regardless of these diminishing balances as a low-cost funding source, transaction accounts may be potentially valuable fee generators. One needs to look no further than continually growing debit card interchange fee income to understand this reality. This is a scale business, however, and a large account base is necessary to effectively lower the unit cost of services. Also, these accounts may not be the critical key to success in overall deposit growth and funding effectiveness.

Assess the liability pricing and effectiveness of the ALCO processes

Of longer-term and more enduring consequence is the need for more effective asset and liability planning processes that drive improved deposit pricing decisions. A quick look at first-quarter earnings reflects the deficit in pricing discipline in the ALCO (Asset/Liability Committee) processes.

Bank after bank now reports compressed margins because assets (loans) re-priced downward more quickly than their deposit base (mostly CDs) in the wake of recent Federal Reserve rate cuts. Every major ALCO model in use today has shock-testing capabilities that would have easily demonstrated that imbalances in funding and asset durations and terms would lead to this result.

There is no alternative – plan for the capture of DDA balances from the competition

In the current environment, it's best to think of deposit growth as essentially a zero-sum game: an individual bank is only going to add lower cost deposits rapidly by beating the other banker to the potential depositor, capturing that business and retaining it.

Take advantage of a potential immediate opportunity in your trust area – a potential exception to the preceding rule

A quick-hit opportunity exists for many banks that also operate trust departments. Until recently, many banks have overlooked the opportunity to retain trust funds invested in money market accounts within the bank. Frequently, these funds are swept (sometimes for a fee but sometimes not) to third-party money market funds. It is a relatively simple matter, so long as it is consistent with prudent exercise of the trust's fiduciary responsibility, to move the balance into the bank rather than to a third party.

Leverage five near-term steps to target and capture deposits

1. Determine where the bank stands in terms of market share across all products by focusing on deposits. It does not take significant work to identify the segments that populate the bank's trade area and its propensity to acquire bank services. Comparing the profiles of the bank's segments to the other segments, populating the market becomes an easy way to understand how effective the bank can be in attracting available and potential new business. Third-party market research firms possess a wealth of information to help identify the gaps and value the potential of growth.
2. Ascertain the causes of gaps found in the market share analysis. The obvious sources of problems are:
 - A lack of adequate advertising, promotion and direct marketing initiatives
 - The absence of scale (and visibility) in some markets. Primary customer and prospect research may be necessary to understand why the bank is not top-of-mind when a prospect is making a buying decision, or, if it was considered, why it did not capture the customer's business



3. The insights from primary and secondary research efforts should form the basis for a series of concrete actions to address deposit shortfalls. The most common outcome is a series of decisions to:
 - Increase spending on new products
 - Add quality sales personnel
 - Utilize a larger array of advertising and promotion to achieve new sales targets for new business. This should be based on market potential
4. Reward real sales growth and do not reward account-churning sales tactics. Set targets and remuneration based on net new business only. If the bank is not setting sales targets and rewarding the acquisition of net new business, the source of deposit growth shortfalls has been discovered.
5. Use insights about market potential to rethink branching strategies and tactics, keeping a clear eye toward exiting markets where the bank cannot be successful given its current position and capacity for further investment. Redeploy scarce resources to higher potential opportunities.

The remainder of this paper discusses additional practical steps that most financial institutions can take to organically grow deposits over time, assuming they maintain a proper focus and persistent methodology.

Strategies and Tactics for Long-Term Deposit Growth

Beyond the previously mentioned immediate steps and actions, the keys to successful, cost-effective deposit acquisition include the following strategies:

Aggressive marketing and promotion of deposit products and services

Merely opening a new office, offering Internet account openings, or operating a 24-hour call center in an attractive market will not generate new business that maximizes deposit market share.

The single largest impediment to deposit acquisition is a lack of name recognition, including insufficient market awareness of the banks' products and services. Waiting for "word of mouth" to spread and bring business leaves bankers standing around with little to do.

If customers are to buy a bank's offerings, the bank has to be seen and heard. The array of cost-effective media for disseminating a bank's message has never been greater. It is time to move beyond that ever-present rate ad to vehicles and become more in tune with today's target customers. A bank should talk to its ad agency, get some creative help, and start thinking and acting outside of the box.

Achieving critical mass and avoiding a minimal presence

Scale economies and utilization efficiencies matter in capturing new business and operating a profitable bank. Achieving a reasonable semblance of size in any market is critical. More offices in a smaller geographic footprint are almost always preferable to single office outposts spread across a larger region.

While there may be some psychological reward derived from being the number-seven bank in a five-bank market and trying harder, this mindset usually ends up being the prescription for an eventual sale in order that shareholders may recapture their investments.

Allocating staff and establishing sales goals based on market potential



It is understandable that bankers strive for control of personnel expense by managing branch staffing. It is likewise clear that the issue facing banks is not so much the quantity of bank staff as much as the disposition of that staff and the tasking of bankers to capture available business.

Identifying and focusing on the volume of business that should be developed given market potential

Less reliance should be placed on merely adding a percentage onto last year's results to set the goal for this year. This action leads to the undesirable effect of embedded underperformance and rewarding the wrong sales force members for nothing more than having the good fortune to be in a good market.

Redeploying from low-potential markets to fund more productive expansion

The resources to pay for marketing and greater market density can be made available by exiting underachieving locations and markets that are absorbing a disproportionate level of spending.

In Summary

Even with the relative decline in DDA balances, banks can take actions to stem the tide – capturing share from the competition and especially the largest banking organizations. Smart bank executives will take advantage of both near-term actions and longer-term strategies that can help them achieve a fair share of core deposits. As supported by research in other FIS white papers, these deposits are critical for the low-cost funding and fee-income generation they provide.

For More Information

The FIS Consulting team of specialists comprises practitioners in financial services, operations, technology, risk management, and retail and commercial banking. Our expertise covers the many facets of deposit growth and branch network effectiveness. For more information on FIS Consulting, call 800.822.6758 or visit www.fisglobal.com.