

Special Report



Deposit-Rate Projection for 2010

HIGHLIGHTS

- Deposit rates are projected to decline in the first half of 2010.
- The main factors suppressing deposit rates are the FDIC rate cap, high unemployment, the Fed rate and the wild card - inflation.
- Inflation could increase deposit rates in the second half of 2010.

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Factors likely to impact Deposit Pricing in 2010

ABSTRACT

The newly-mandated FDIC rate cap, effective January 1st, 2010, is going to force rates down for a substantial number of banks. This factor combined with the high unemployment rate and the low Fed's rate, are going to suppress deposit interest rates down during the first half of 2010. The big unknown is the rate of inflation, which could push deposit rates back up if inflation starts to appear in the second half of 2010.

OVERVIEW

This report examines four different factors that are very likely to impact deposit interest rates through 2010. The four factors are: 1) The FDIC rate caps and undercapitalized banks, 2) The unemployment rate, 3) The Fed rate and 4) The wild card – inflation. Based on empirical analysis and observations of these four factors, we believe that they will play a role in the level of interest rate for deposit products in 2010.

FINDINGS

1. Under capitalized banks tend to price deposits more aggressively, compare to well-capitalized banks, up to the point of failure or rate restrictions by the FDIC. The average variance in the first three quarters of 2009 was 59 bps.
2. Small and mid-size banks tend to price deposit higher than the top 19 banks (Stress test banks). The average variance in the first half of 2009 was 61 bps.
3. Under capitalized banks will find it harder to compete on rates in nine states, where the average maximum rate is higher than the FDIC rate cap. These nine states are (from highest to lowest): WA, NC, CA, TX, FL, NV, ID, OR and MN.
4. The unemployment rate is a predictor of deposit interest rates. When the unemployment rate is high, the interest rate on deposits is low and vice versa.
5. The Fed rate is not likely to increase in the first half of 2010; possibly not until 2011.
6. Inflation is not likely to increase in the first half of 2010, but may appear in the second half of the year.

IMPLICATIONS

There is a very high probability that deposit interest rates will continue to decline, or at best stay flat, in the first half of 2010. At this point, it is not clear how deposit interest rates will evolve during the second half of 2010 mainly due to the big unknown – inflation, or lack thereof.

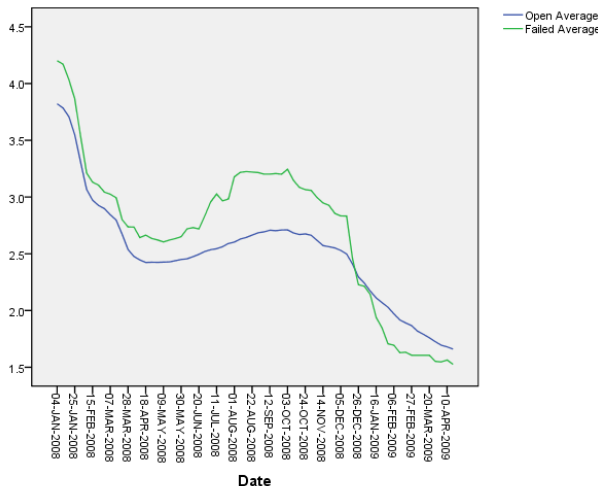
ANALYSIS

FDIC rate cap and undercapitalized banks

On January 1st of 2010, the FDIC rate cap becomes mandatory for less than well capitalized banks and banks subject to a capital maintenance provision. (FDIC Final Rule 2009). This means that, in most cases, banks that fall under this category will not be able to price their deposit products above the FDIC rate cap. Currently, there are 552 “problem” institutions (FDIC Quarterly Banking Profile 2009) that are under capitalized, which means that about 7 percent of all FDIC insured insinuations will have rate restrictions.

An analysis of the pricing variance between under-capitalized banks and well-capitalized banks (Geller 2009)) found that banks with liquidity problems tend to price deposits higher than well-capitalized banks up to the point of rate restrictions or a take over by the FDIC. The analysis found that the average APY for deposit products of under capitalized banks was 59 basis points higher than the average APY of well-capitalized banks (Figure I).

Figure I - Average CD rate of failed banks (undercapitalized) vs. open banks

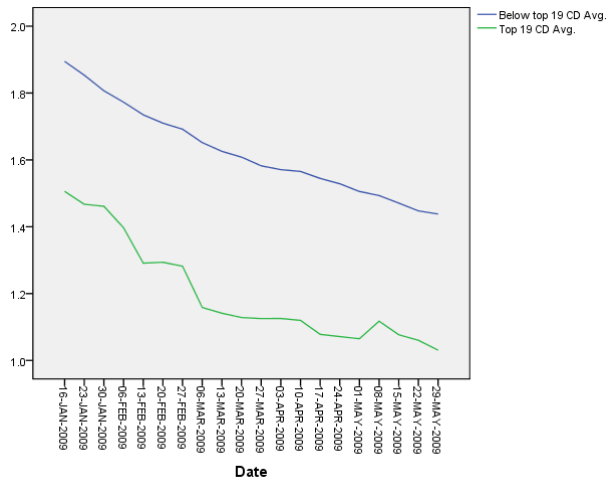


Source: Market Rates Insight

Furthermore, since the majority of the undercapitalized banks today are mid to small-size banks, and since the mid to small-size banks typically price higher than the “Top 19” banks (19 banks subjected to the Stress Test), the impact of the FDIC rate cap on the national average will be even greater.

An analysis of the rate variance between the “Top 19” banks and all others (Geller 2009) shows that the average deposit APY of the “Top 19” banks has been below the average deposit APY of the below top-19 banks by as much as 61 basis points on some deposit products (Figure 2)

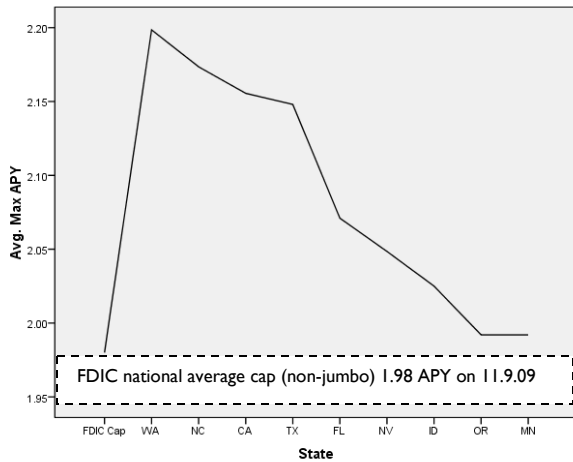
Figure 2 - Average CD rates of the “top 19” banks vs. all other banks



Source: Market Rates Insight

The findings of a separate analysis on the impact of the FDIC rate cap on the different pricing regions (Geller 2009) indicate that there are nine pricing regions (states), where the highest market rate exceeds the FDIC rate cap. Among these nine states are the top three states in total deposits: California, Texas, and Florida. This means that undercapitalized banks will not be able to price their deposit products, in these nine states, high enough to compete with higher deposit rates – hence lowering the average rate for deposits in that pricing region (Figure 3).

Figure 3 - Nine pricing regions (states) were the FDIC cap is below the maximum rate



Source: Market Rates Insight

The combination of all these findings indicate that we should expect deposit rates to go further down once the FDIC Final Rule because mandatory on January 1, 2010. The reason lower rates are expected is because a substantial number of under-capitalized banks (552), which historically priced their deposits higher than well-capitalized banks, will have to lower their rates thus impacting the average rate for deposits nationally.

National unemployment rate

The unemployment rate is a significant predictor of deposit interest rates. An analysis by Market Rates Insight (Geller 2009) found that 79.1 percent of the variance in the average interest rate for deposits can be explained by the variance in the unemployment rate, and that the unemployment rate and the national average APY have a very strong (Beta -.889) and significant (Alpha <0.01) linear relationship (Table I).

This means that when the unemployment rate is going up, the national average APY for deposits goes down, and when the unemployment rate drops, deposit rates increase. For every 1% increase in the unemployment rate expect a 49 bps drop in the national average APY for deposits

Table I - Linear relationship between unemployment rate and national average deposit APY

Model Summary

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|-------|-------------------|----------|-------------------|----------------------------|
| 1 | .889 ^a | .791 | .787 | .40490 |

a. Predictors: (Constant), Unemployment rate

ANOVA^b

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|-------|------------|----------------|----|-------------|---------|-------------------|
| 1 | Regression | 34.081 | 1 | 34.081 | 207.882 | .000 ^a |
| | Residual | 9.017 | 55 | .164 | | |
| | Total | 43.098 | 56 | | | |

a. Predictors: (Constant), Unemployment rate
b. Dependent Variable: National Average APY

| Model | | B | Std. Error | T | Sig. |
|-------|-------------------|------------|------------|---------|--------|
| 1 | Unemployment rate | -.889 | .034 | -26.111 | .000 |
| | | (Constant) | 2.630 | .188 | 13.988 |

Coefficients^a

In January of 2005, the unemployment rate was 5.20 percent and the national average interest for deposits was 2.63 percent. In March of 2007, the unemployment rate declined to 4.20 percent, and the national average interest rate for deposits increased to 4.25 percent. In September of 2009, the unemployment rate increased to 9.80 percent, and the national average interest rate for deposits declined to 1.55 percent.

In November 2009, the national unemployment rate stands at 10 percent, and the projection is that the national unemployment rate might even go as high as 10.5% in the first half of 2010. Although the job-loss figures declined lately compare to its high in the first part of the year, there is a strong probability that it will go back up after the holidays due to projected marginal performance of the retail industry and lay off of seasonal employees.

Federal Reserve officials believe the recovery is going to expand at a slow rate while unemployment will continue to remain high, according to the minutes of their closed-door Nov. 3 and Nov 4 meetings. The Fed forecast that the unemployment rate could stay elevated in 2010 at 9.7% and would only drop modestly to 8.6% in 2011, according to the summary of the latest meetings. The unemployment rate hit 10.2% in October, a 26-year high (Oro 2009),

Based on the likelihood of high unemployment rate in 2010, and the strong relationship between the unemployment rate and deposit rates, it is very likely that deposit rates will remain suppressed during most of 2010.

Fed rate

The Fed rate, which is currently 0 to 0.25 percent, is very likely to remain the same for the first two or three quarters of 2010. The two main reasons the Fed rate is not expected to change before mid to late 2010 because: 1) The US economy grew by only 2.8 per cent between July and September, far below the original 3.5 per cent estimate, and 2) The Fed's focus right now is on dealing with the threat of deflation.

According to James Bullard, the President of the Federal Reserve Bank of St Louis, the US central bank still faces a lingering threat of deflation, but might have to pivot quickly once this danger passed to face the threat of excess inflation (Reuters 2009).

Moreover, the St Louis Fed President said he would not favor tightening policy before recovery was well-established. "You are going to need to have jobs growth and you are going to need to have unemployment declining." However, Bullard continues, "What is different this time is that the argument about staying too low for too long is going to weigh pretty heavily on the committee. It is more than just: 'What does the output gap look like; what does inflation look like?'" (Reuters 2009).

Based on the current conditions that traditionally trigger increase in the Fed rate, it is very unlikely that the Fed will increase rates any time before the third quarter of 2010 or even later than that.

Inflation

The wild card of all the examined factors, which are likely to impact deposit interest rates in 2010, is inflation.

Traditionally, the central bank waited two to three years after the beginning of a recovery before it started raising rates. However, according to Bullard, the current situation is different because keeping the Fed rate too low for too long can create a bubble that will hurt the economy later on.

On the other hand, according to Bullard, we might be experiencing inflation "as high as it has ever been since 1980"(Reuters 2009).

The outlook for the next two to four years, according to Bullard, is that "you have inflation that will be possibly substantially above target over a horizon of two to four years, and that, I think, is because of the combination of very large fiscal deficits in the U.S. with very easy monetary policy." Bullard also said that for 2009 and "maybe a little bit into 2010", the focus would be on recovery" (Reuters 2009).

We are facing a balancing act between the "traditional" approach, which called for an increase in the Fed rates only two to three years after the beginning of a recovery, and the need to control inflation, which can be as high as it was during the early 1980's. Which forces will prevail is too soon to tell.

One early warning sign for inflation is the increase in inflation-protected investments such as bonds and mutual funds that are linked to the inflation index.

The Wall Street Journal reports that "To defend—and profit—from a big rise in inflation, investors have piled into gold or inflation-protected bonds. In November, investors put \$2 billion into inflation-protected mutual funds and exchange-traded funds, according to Morningstar Inc. Another \$3.9 billion into went into commodity funds and commodity exchange-traded funds, primarily gold funds. So far this year, those categories of funds have raked in \$59 billion." (Lauricella 2009).

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About the Author

Dr, Dan Geller is the Executive Vice President at Market Rates Insight, overseeing the research and analytics services of the company. These research and analytics services provide value added to clients, over and beyond the standard rate surveys, by helping them interpret the data, identify trends and price their deposit products with the utmost precision and competitiveness.

Among the many projects headed by Dr. Geller are the publication of the weekly National Pricing Indicators, special reports on trends in the banking industry and predictive analytics for deposit pricing. Dr. Geller has worked with many banking clients on establishing a scientifically-based model for deposit pricing that allows pricing executives to price their deposit products quickly, easily and with a high level of predictive outcome such as impact on balances.

Dr. Geller earned his Ph.D. in Business Administration from TUI University, and has published numerous peer-reviewed studies in scientific publications.

About Market Rates Insight

Market Rates Insight (MRI) is the premier provider of competitive-pricing information and analysis to the banking industry. MRI focuses on serving the pricing needs of financial institutions—not consumers. Therefore, only MRI offers the higher level of pricing comprehensiveness and sophistication of systems demanded by the industry.

In addition to competitive-data that MRI provide to financial institutions, MRI also provides analysis and tracking of industry indexes to thought leaders worldwide. Among them are The Wall Street Journal, American Banker, Credit Union Times, Thomson Reuters and others. MRI's analysis and indicators are viewed weekly by many thousands of banking and credit union professionals

THE WALL STREET JOURNAL

Banks Wage Rate War for Deposits

By *DAVID ENRICH*

Consumers Benefit as Institutions Move to Shore Up Funds, but Profit Margins Suffer

Unlike previous periods of turbulence, the Fed's rate-chopping campaign isn't relieving the pressure this time. In the past, reductions in the federal funds rate have helped level off interest rates on CDs and savings accounts, according to **Market Rates Insight Inc., which tracks pricing trends for financial institutions.** "This time around, it's much more fierce," says Dan Geller, executive vice president of the San Anselmo, Calif., firm.

BusinessWeek

Should You Test-Drive a Hybrid CD?

By *David Bogoslaw*

Since June, rates for indexed CDs have climbed an average of 8.1%, while non-indexed rates have declined more than 14%, according to Dan Geller, executive vice-president of **Market Rates Insight, which provides competitive-pricing information and analysis to the banking industry.**

"This is the type of deposit that low-risk-minded people can take and sleep well at night because, unlike investing in the stock market or a mutual fund, it will not impact your principal adversely if the market goes down," he says. "Granted, the return potential is not as

AMERICAN BANKER

On Focus and In Depth

To Predict Deposit Rates, Take a Look at Jobs Data

By *Katie Kuehner-Hebert*

When the unemployment rate is high and economic activity low, the need for deposits to fund loans is less acute, said Dan Geller, executive vice president at **Market Rates Insight, a San Anselmo, Calif., firm that tracks deposit pricing.** That means banks can pay "the minimal amount they can get by with on deposits."

The Market Rates Insight study found that nearly 80% of the movement in the national average rate on

CREDIT UNION TIMES

Short-Term CDs a Hot Commodity

By *Michelle Samaad*

"It's a mixture of uncertainty and the job market," said Dan Geller executive vice president of **Market Rates Insight, a San Anselmo, Calif. firm that tracks rates loans, fees and rates.** "The bottom line is people prefer to make short-term commitments in case they need the funds."

According to 1,300 banks and credit unions tracked by **Market Rates Insight,** the premium paid on short-term CDs increased from 66.3% in January to 100.4% in September, an increase of 34.1%. Short-term CDs are defined as those with a one year or less term. Mean-