

Annual Report

JANUARY 2011						
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Deposit Trends and Projection for 2011

Synopsis

The overall economy will exhibit mild and gradual improvement in 2011. However, deposit rates will remain low for most of the year. Total deposit balances will increase but with a shift from term to liquid accounts.

Leveraging these trends can help reduce cost of funds and retain existing balances and customers (Page 8).

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OVERVIEW

Traditionally, deposit decisions were rationally based and followed the price-elasticity-of-demand theory, which asserts that deposit balances should decrease when interest rates on deposits decrease and vice versa. However, during and after the last recession (officially from December 2007 to June 2009), exactly the inverse has occurred.

The main reason for this reversal is the introduction of emotion related factors – mainly fear related to economic uncertainty – to the deposit decision process. These factors are variables that can't be observed, but their impact can be measured. In this case, for example, although we can't observe fear, we can measure its impact on deposit balances in conjunction with the traditional indicators that influence deposit decisions, such as interest rates, Fed Funds Rate, inflation rate and others.

In 2011, consumers are going to make deposit decisions based on an unusual combination of indicators and factors, which will impact products and balances in an uncustomary manner. Moreover, the impact is likely to vary by product and by pricing region.

DEPOSIT PROJECTION FOR 2011

Balance Growth

Expect modest **increase in deposit balances** in 2011 due to the following trends:

- Persistent uncertainty about the prospect of near-term economic recovery causes consumer to gravitate towards the safety and security of FDIC insured deposits (Page 3).
- Volatile equity market makes the average consumer nervous about alternative investments despite the potential for higher returns. The memory of the losses in 2008/9 is still fresh (Page 3).
- The extension of the Bush-era tax cuts will positively impact deposit balances due to the very strong and significant relationships between disposable personal income and savings (Page 5).

Balance Shift

Expect continued **shifting of balances from term to liquid** accounts due to the following trends:

- Dropping deposit rates have reached a point of minimal yield differentiation between some term accounts and liquid accounts. Currently, the national average rate on a 9-month CD is the same as the national average on a MM account (Page 4).
- Diminishing yield differentiation between term and liquid accounts, combined with the temporary unlimited insurance coverage for non-interest bearing transaction accounts (Dodd-Frank section 343), will shift some balances from CD, MM and savings accounts to transaction accounts (Page 5).

Low Rates

Expect continued **gradual decline in deposit rates** in 2011 due to the following trends:

- Traditionally, deposit rates mirror fluctuations in the Fed Funds Rate, which rises when inflation increases. However, the high unemployment rate will likely delay any near-term rise in the Fed Funds rate.
- A similar scenario occurred after the recession of 2000, when the inflation rate increased from 1.07% in June of 2002 to 3.02% in March of 2003 yet the Fed Funds rate did not rise right away, which caused deposit rates to remain low (Page 6).

INTRODUCTION

The current state of mind of bank consumers is best illustrated in a verbatim statement made by a bank customer, when commenting on an article featuring our analysis of the \$1 trillion added to deposits since the start of the last recession in late 2007 (Exhibit A).

Exhibit A - Verbatim statement by a bank customer portraying current state of mind

“We aren't saving so much as not spending (not exactly the same) because we are scared. I might lose my job in a week, so, even though I make good money, I am not going to spend NOR will I invest in traditional vehicles because I need the money liquid and I cannot afford to gamble and lose. I am going to let money pile up in the bank in case I need it, to pay rent and buy food.”

Source: Reader of mainstreet.com commenting on article featuring MRI analysis
www.mainstreet.com/article/moneyinvesting/savings/americans-add-1-trillion-savings

This statement captures the essence of the trends we are currently observing in deposit balances, which are impacting the type and amounts of deposit products consumers select. These trends will continue to have similar impact through 2011 and possibly into 2012. Understanding these trends, and acting accordingly, will help institutions maintain profitable relationships with their current customers, and acquire new and profitable customers, as long as they consider two implications.

First, in times of uncertainty, people gravitate towards safety. In the context of bank deposits, the assurance that money is insured by the Federal Deposit Insurance Corp. provides a high comfort level to many bank customers. This means that we should expect to see deposit balances grow, regardless of interest rates, as long as the economic uncertainty persists.

The second implication is the consumer preference for liquid accounts over term accounts. The knowledge that deposited money can be withdrawn right away without penalty is comforting to people who feel unsure about the stability of their jobs. Therefore, expect two trends to continue in 2011 and for as long as the current economic conditions persist: 1) Increase in some deposit balances regardless of low interest rates, and 2) gradual shift of maturing certificate of deposit (CD) balances to liquid accounts, mainly money market accounts.

These two trends can be leveraged by pricing managers to improve the performance of their institutions. For example, reduction in cost-of-funds can be accomplished by identifying inverse-elastic products and reducing their annual percentage yield with high confidence that balances will not decrease and might even increase. Also, retention of current customers and balances can be furthered by determining the liquidity point of each pricing region and contacting maturing CD customers, who have terms below the liquidity point, before they withdraw the money or move it to a liquid account.

Trend Analysis

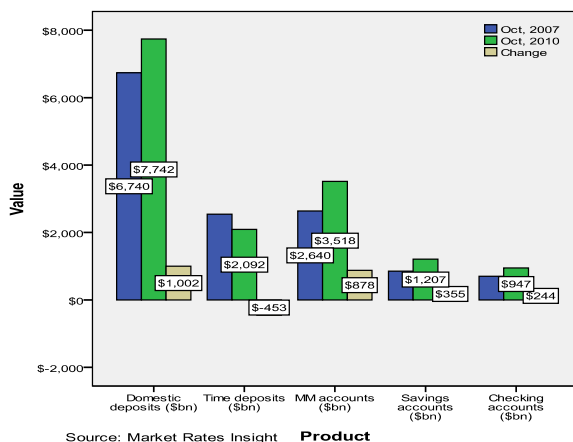
Balances growing despite declining rates

In the past three years, deposit balances defied the conventional theory of price elasticity of demand, which asserts that deposit balances should decrease when interest rates on deposits decrease. Since October 2007 exactly the reverse has occurred. Deposit balances increased by one trillion dollars despite substantial decrease in deposit APY - a phenomenon we termed “inverse elasticity”.

Interest rates on deposits started declining around October of 2007, which was the official start date of the last recession. At that time, the national average rate on deposits stood at 3.38%, and domestic deposits totaled \$6.74 trillion. Three years later, in October of 2010, the national average rate for deposits dropped to 0.80% (a decline of 76% in return value). Despite such a substantial decrease in rates, deposit balances increased to \$7.74 trillion - an increase of one trillion dollars.

Another evidence of “reverse elasticity” is the shift in balances from term accounts to liquid accounts such as MM, savings and checking even though these accounts yield lower interest rates than term accounts (Figures 1).

Figure 1 – Balances change Oct. 2007 to Oct. 2010



Consumers are one-third less confident

Consumers are exhibiting one-third less (36 index points) confidence in the economy during the current downturn in deposit rates compared to the previous deposit rate dip in January of 2004. The Consumer Sentiment Index, produced by the University of Michigan (aka MCSI), has a strong and significant relationship to the national average rate for deposits. In January of 2004, which was the previous record low for deposit rates, the MCSI stood at 103.8. In July of 2010, the new record low for deposits rates, the index dropped to 67.8 (Figure 2). The national average rate for deposits stood at 1.88 in January 2004, compare with 0.99 in July of 2010 (Figure 3)

Figure 2 - - Consumer Sentiment Index at 67.8

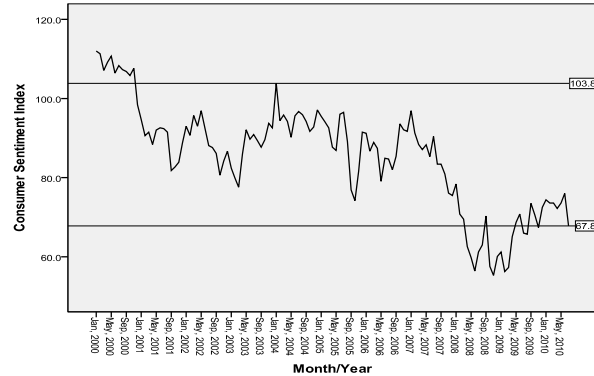


Figure 3 - National average APY at 0.99 on July 2010



Trend Analysis

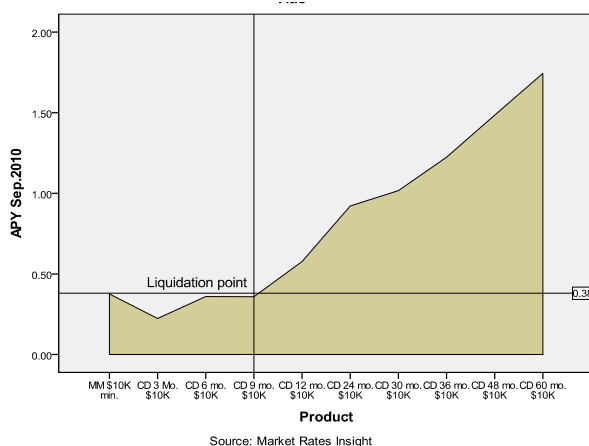
The national liquidation point is raising

The national liquidation point, where the rate of MM account and the rate of term deposits converge, reached the 9-month term in September of this year. In January of this year, the liquidation point was at zero, meaning all terms rates were higher than MM rate.

The national average rate for MM at the end of September was 0.37 percent and for 9-month CD 0.36 percent. Thus, there is no yield incentive to lock money in term accounts up to 9 months since they pay equal or less than the MM account. In comparison, the liquidation point in January of this year was zero term, since the average MM account paid 0.69 percent, and the 3-month CD paid 1.07 percent (Figure 4).

The higher the liquidation point, the more money is flowing out of term accounts into liquid accounts. Between January and September of this 2010, \$207 billion was liquidated out of maturing short-term CDs and transferred to MM accounts. About \$95 billion came from CDs of up to 3 months, and \$112 billion came from maturing CDs of 3 to 12 months.

Figure 4 - National liquidation point at 9-month term



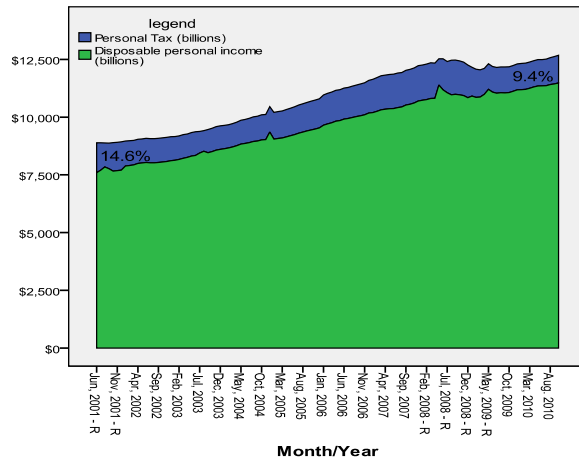
Tax-cuts extension will increase deposits

The tax cuts, which were enacted in June 2001, and have been extended for two more years, have stimulated growth in deposits. In the nine plus years since the enactment of the tax cuts, domestic balances of deposits increased by \$3.4 trillion; up from \$4.3 trillion in June of 2001 to \$7.7 trillion in October of 2010.

About 98% of the growth in deposits is attributed to the increase in disposable personal income. These two variables have very strong linear relations (Beta .991), and very significant (Alpha <0.01). Since the tax cuts decreased the relative tax on personal income, the amount of disposable personal income has increased at a higher rate than it would otherwise grow had the tax cuts not been enacted.

Specifically, the percentage of personal tax decreased from 14.6% in June of 2001 to 9.4% in October of 2010 - a decrease of 5.2%. The reduction in the percentage of personal tax has increased the amount of disposable personal income, which was allocated to additional savings in deposits and to increased personal consumption in nearly identical amounts (Figure 5).

Figure 5 - Impact of disposable personal income on



Trend Analysis

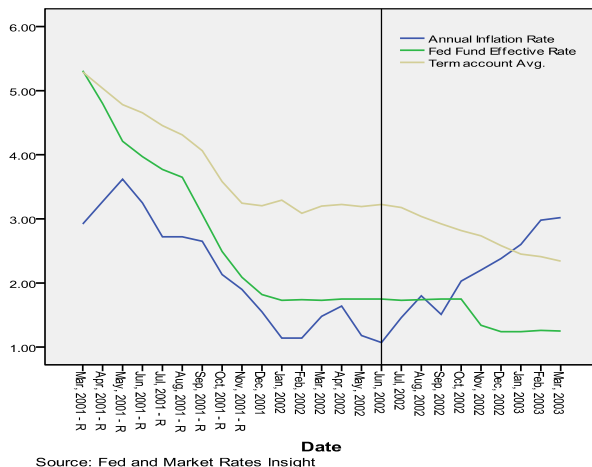
Fed Funds, Inflation and unemployment

The market is anticipating inflation to rise. A recent auction of five-year TIPS (Treasury Inflation-Protected Securities) at a negative yield of -0.55% was a signal that the market is hedging against anticipated higher inflation. But, higher inflation does not necessarily mean higher deposit rates..

The inflation rate, by itself, is not a strong predictor of deposit rates. The Fed Funds effective rate is, which means that even if the inflation rate increases deposit rates may not increase if the Fed Funds effective rate does not increase in response to a higher inflation rate.

For example, in June 2002, the national inflation rate hit a low of 1.07%, and started climbing up to peak at 3.02% in March 2003. However, the Fed Funds effective rate decreased from 1.75% to 1.50% during the same time period. As a result, the average deposit rate decreased from 3.23% to 2.34% despite the increase in the inflation rate over the same time period (Figure 6).

Figure 6 - Rising inflation and Fed Funds rate in 2002/3



Source: Fed and Market Rates Insight

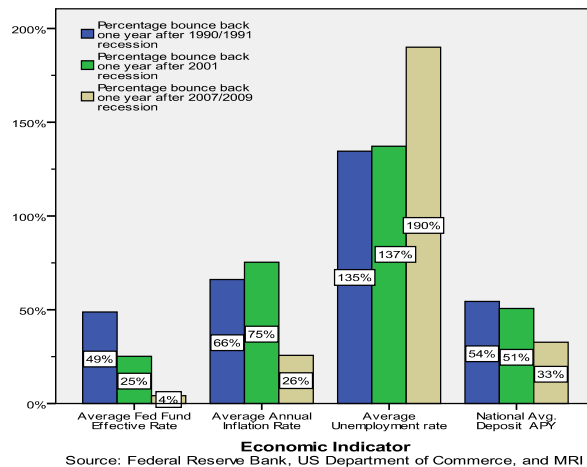
Deposits' rates - why so low for so long?

By comparing the bounce-back rate of major economic indicators during the last three recessions, we can gain insight into how long deposits' rates will remain low. Bounce-back rate is the ratio between the indicators' pre-recession level, and one year post-recession level.

One year after the official ending of the 1990/1991 recession, the Fed Fund effective rate bounced back by 49% of its pre-recession level; the annual inflation rate bounced back by 66%; the unemployment rate bounced back 135% (higher unemployment rate) and the national average deposits' rate bounced back 54% from of its pre-recession level (Figure 7).

Conversely, in the last recession of 2007/2009, the Fed Fund effective rate bounced back only by 4% of its pre-recession level; the annual inflation rate bounced back 26%; the unemployment rate bounced back 190% (nearly twice its pre-recession level), and the national average deposits' rate bounced back only 33% - lower than the over 50% bounce-back in the last two recessions.

Figure 7 - Bounce-back rate one year after recessions



Source: Federal Reserve Bank, US Department of Commerce, and MRI

Historical prospective

Full circle in half a century

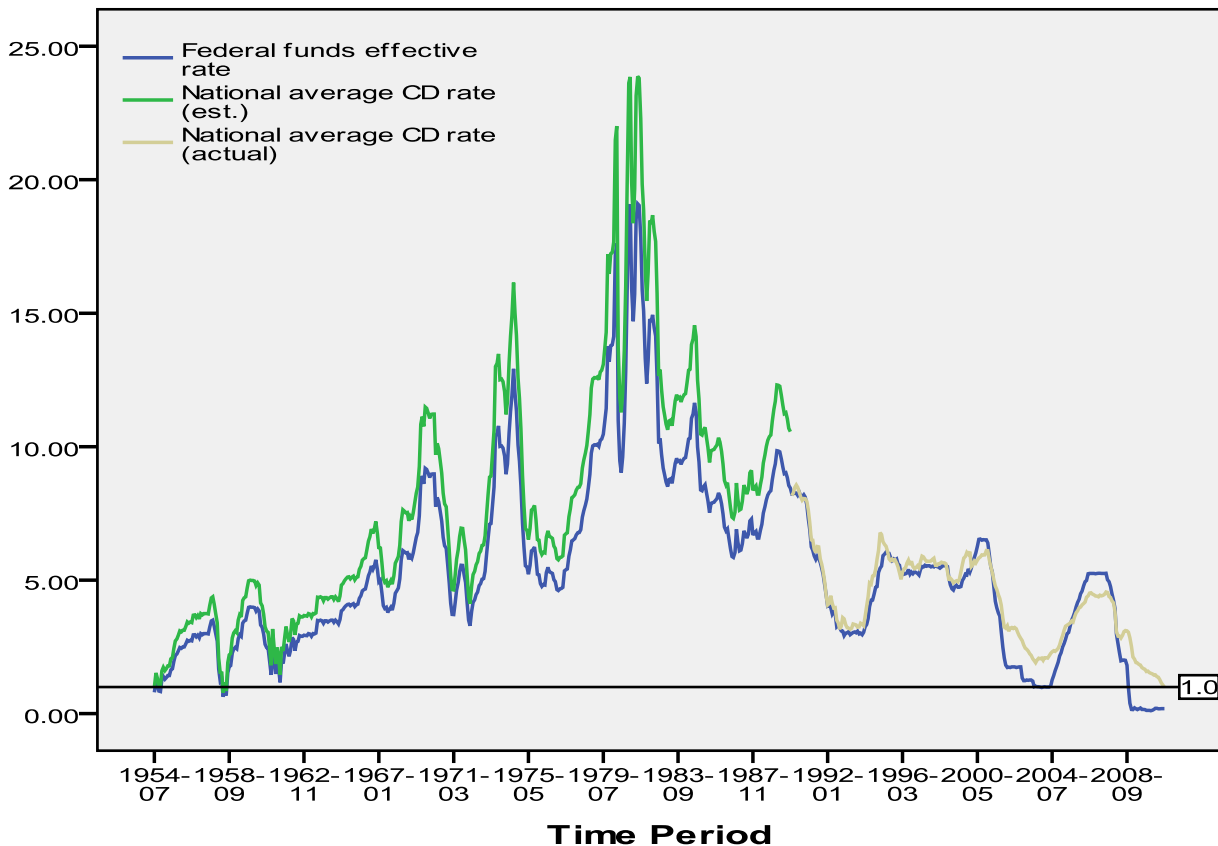
CD rates went full circle in the past 50 plus years. The last time the national average rate for CDs was identical to the rate today was in July of 1954, when the estimated national average for CDs was at 1.0 Percent. It took CD rates about the same number of years (27) to reach their peak and back.

During its full circle, between 1954 and today, the national average rate for CDs went up from 1 percent at its lowest point to peak at 24 percent in June of 1981, when the actual Fed Funds effective rate stood at 19.10 percent. From its peak in mid 1981, the national average rate for CD declined gradually all the way to Oc-

2010, when it just dipped below 1 percent (Figure 8).

The national average CD rates from 1990 until today is based on actual historical data. The national average rate for CDs from 1954 to 1989 was calculated using regression analysis since there are no official records of CD rates going back to the 1950's. Based on the linear relationship between the actual national average CD rates from 1990 to today, and the Fed Funds effective rate, which is very strong (Beta .965) and highly significant (Alpha < 0.01), it was possible to project the national average CD rate with a confidence level of 95%.

Figure 8 - National average CD rate and the Fed Funds effective rate from July 1954 to October 2010



Source: Federal Reserve Bank and Market Rates Insight

How to leverage deposit trends to lower cost of funds and retain existing balances and customers in 2011

In 2011, consumers are going to make deposit decisions based on an unusual combination of indicators and factors, which will impact products and balances in an uncustomary manner. Moreover, the impact is likely to vary by product and by pricing region.

There are two analytical methods that can be utilized to identify potential for cost of funds reduction and retention of existing balances and customers in different markets.

- **Market Elasticity Analysis** - identifies opportunities for lower cost of funds.
- **Liquidation-point Analysis** - prevents liquidation of term accounts and loss of customers.

Market Elasticity Analysis

The Market Elasticity Analysis is instrumental to making profitable pricing decisions - especially in low-rate environment. The analysis points to specific products, in your specific markets, that can be offered at a lower APY without adverse effect on balances. Thus, you can lower your cost of funds and improve the profitability of your institution.

The market Elasticity Analysis is a projection of changes in balances and rates for a specific MSA. It is produced four times a year in advance of each quarter, and provides you with critical projections for each of your major deposit-product types (Checking, Saving, MM and CDs).

Specifically, the Market Elasticity Analysis will help you:

- Identify deposit products that exhibit inverse elasticity, and can sustain lower rates.
- Assess the impact of rate changes on balances of each of your deposit-product types.
- Gain foresight into quarterly projection of APY for each of the deposit-product types.
- Gain foresight into quarterly projection of balances for each deposit-product type.

Liquidation-Point Analysis

The Liquidation-Point Analysis helps identify maturing CD balances that could potentially be moved to a liquid account, or leave your institution.

This advance knowledge can help you contact owners of maturing CDs of specific terms and in specific markets, and offer them an incentive to roll-over their CD to another term.

The current national trend shows a shift from term accounts to liquid accounts. However, this trend is not homogenous, and some term-account balances are actually growing, and each pricing region has a different dynamics of balance movement from term to liquid and vice versa.

Specifically, the Liquidation-Point Analysis will help you:

- Examine the balance mix for each product type in your pricing region (MSA).
- Identify maturing CD balances that are most likely to shift to liquid or go elsewhere.
- Gain foresight into quarterly projection of the region's balance mix.
- Examine the historical shift in product-mix

- **If you would like to discuss how these analyses can help you with your pricing program, or to request sample reports, just contact: dan.geller@marketratesinsight.com**

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.

