Fed Keeps Rates Steady, But Get Ready for Them to Rise

By Peter Serene, Adam Stockton and Richard Martin

The Fed didn't increase the target range for the Federal Funds rate today, but policymakers continued to set expectations of significant rate increases this year, likely starting in March. With rising rates upon us, Curinos is reviving our series of Perspectives that provide critical analysis on the heels of the Fed's meetings.

While trends from the prior rising-rate environment will remain instructive, market conditions are very different now compared with seven years ago. That means different tools will be necessary to ensure success. In addition to the target Fed Funds rate, market participants will watch closely for guidance on the timing of Fed balance sheet reduction.

Furthermore, while the Fed's actions are certainly expected to be the primary focus for financial-services providers, geopolitical risks (Russia/Ukraine) as well as continued pandemic uncertainty have the potential to influence markets and the overall rate environment.

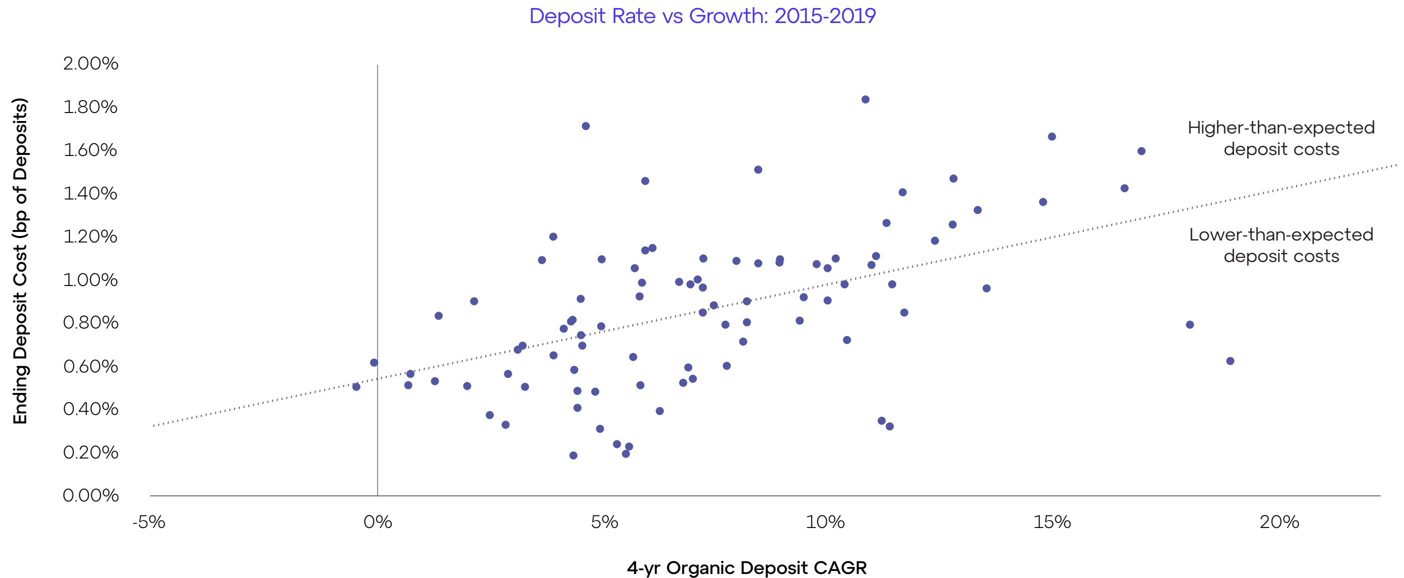
EXCESS LIQUIDITY SUGGESTS DEPOSIT RATES WILL LAG, BUT NOT UNIVERSALLY

The most significant change since the last rising-rate cycle (late 2015-late 2018) is the substantial excess liquidity in the system. (See Figure 1.) With multiple stimulus programs (notably EIP and PPP) and the unprecedented monetary support from the Fed generating deposits, more than $3 trillion of so-called surge deposits remain in the system. The effect has been a dramatic decrease in the industry's loan-to-deposit ratio, falling to 30-year lows across nearly all bank segments. (See Figure 2.)

With more deposits than can be deployed, the right strategy for most banks will be to lag the Fed's actions aggressively. In the prior cycle, the industry largely lagged the first four Fed increases, although rates were at a much higher starting point. We expect a similar trend to hold, especially given the excess liquidity.

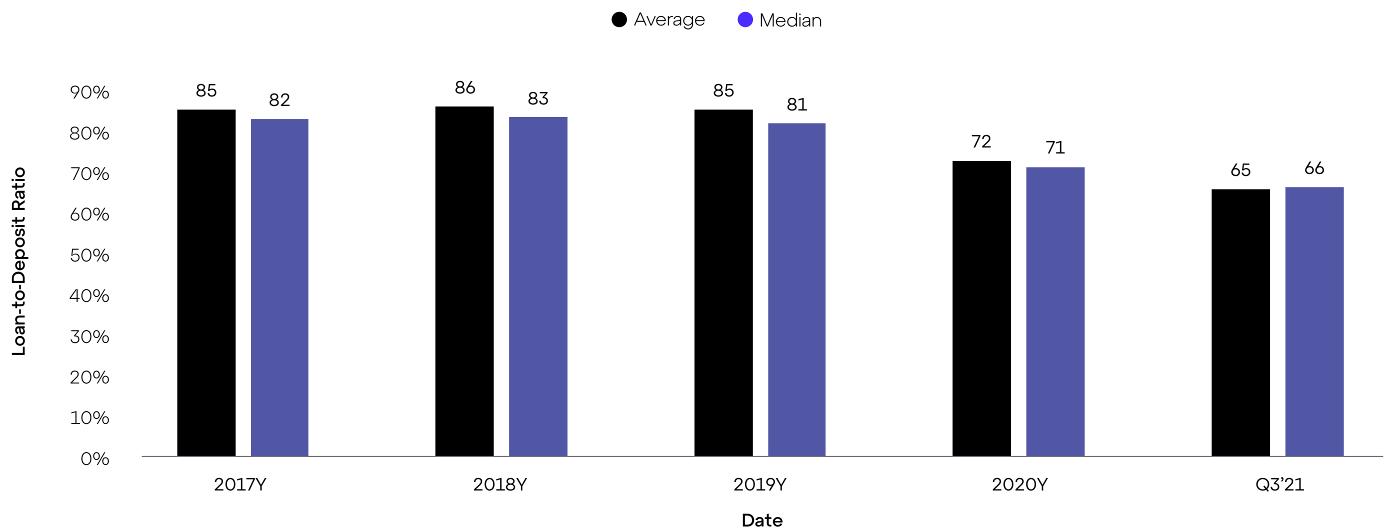
Just because most banks have excess liquidity, however, doesn't mean the situation is universal. Banks with lower concentration of primary relationships haven't seen the same level of surge deposits; this includes direct banks and fintechs, which generally have very low levels of primary checking accounts. Similarly, there is a modest number of regional banks with lower surge deposits and higher loan growth that may need to raise rates to grow deposits.

Figure 1: There is strong correlation between deposit growth and costs, but there were clear winners and losers in the last cycle.



Notes: Growth between 2015Q2 and 2019Q2 | Ending rate as of 2019Q2 | Growth rates are acquisition-adjusted | Includes all traditional / brick and mortar banks above $20B in assets
Sources: Curinos Analysis, SNL Financial

Figure 2: Total Loan-to-Deposit Ratio (National and Regional Sample)



Representative sample of 30 national and regional banks, excluding those with unconventional balance sheet structures.
Sources: SNL Financial

This will mean that banks may see pricing pressure begin to emerge later this year from select competitors even though they may not need deposit growth themselves.

In the commercial space, where exception pricing is commonplace, there is another layer of complexity that is tied to recent learned behavior. In the late stages of the last rising-rate cycle, clients and bankers became accustomed to interest-bearing deposit betas in excess of 70% on exception-priced balances. To lag rate hikes this time, bankers will need to be equipped with client-ready explanations for why pass-throughs are lower than before. The bank may have good reasons for this, of course, but it's a challenging narrative.

RELATIONSHIPS AND DEPOSIT VALUE WILL BE KEYS TO SUCCESS

As competition begins to ramp up, the question facing many banks will be which customers to retain and which to allow to seek higher rates elsewhere.

In previous rising-rate cycles, banks used an elasticity framework to guide pricing decisions. This time is different. In a cycle where banks don't need or necessarily want every deposit, the optimal framework is customer relationship primacy.

To apply a primacy framework, the first step is to define and measure primacy. Banks and their clients now define primary relationships based on the main checking account. This is equally true of individuals and companies.

But while there is general agreement on what primacy is, there is less agreement on how to measure it — especially in more complex commercial relationships. Moreover, leading primacy frameworks measure not just how likely it is that you are currently the primary bank, but also how strong the potential is to become the primary bank. This requires both sophisticated analytics of current customer data and insights into customers' financial needs outside of the bank.

Once banks have systematically measured primacy, they can apply a pricing framework where rate is used strategically to retain existing primary relationships and deepen high potential non-primary relationships.

It is also important for banks to understand deposit value. If a customer is retained, how likely are they to remain with the bank for the entire rate cycle? Will they continue to seek rate with every Fed increase or only look for periodic adjustments?

The biggest banks have invested significantly in measuring these types of behaviors, leaving the rest of the market to catch up. Other providers need to develop these surgical retention strategies now, for deployment later.

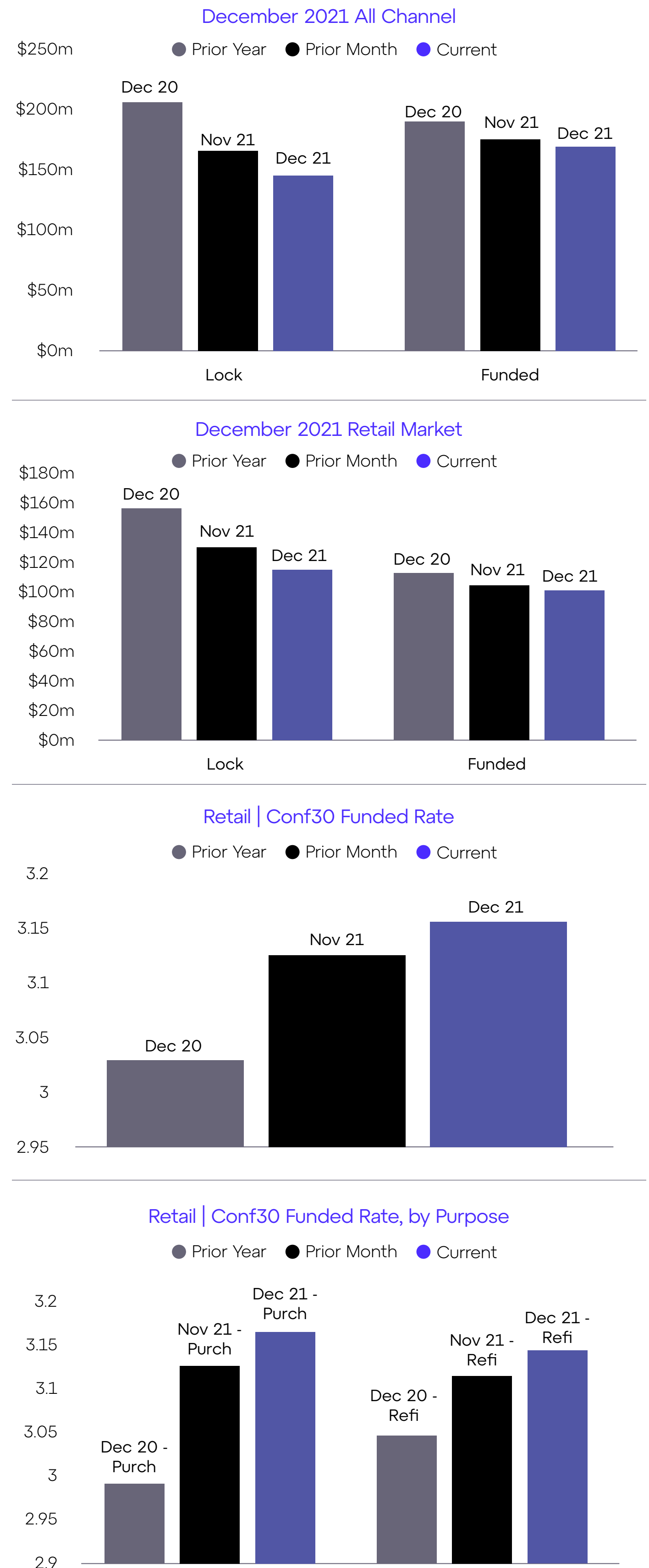
MORTGAGE MARKET IS ALREADY ON THE MOVE

Meanwhile, home lenders aren't waiting for the Fed to move. Mortgage rates have already begun 2022 on an elevated trajectory relative to market forecasts and expectations, reaching their highest levels since the beginning of the pandemic. (See Figures 3 and 4.)

Much of this market response seems to be predicated on the anticipated Federal Reserve rate hikes throughout 2022 alongside the more aggressive tapering timeline of Fed asset purchases of treasuries and mortgage-backed securities. With inflation at its highest level in 40 years, the Fed's response and forward guidance will be critical as lenders transition to higher rates and less accommodative monetary policies.

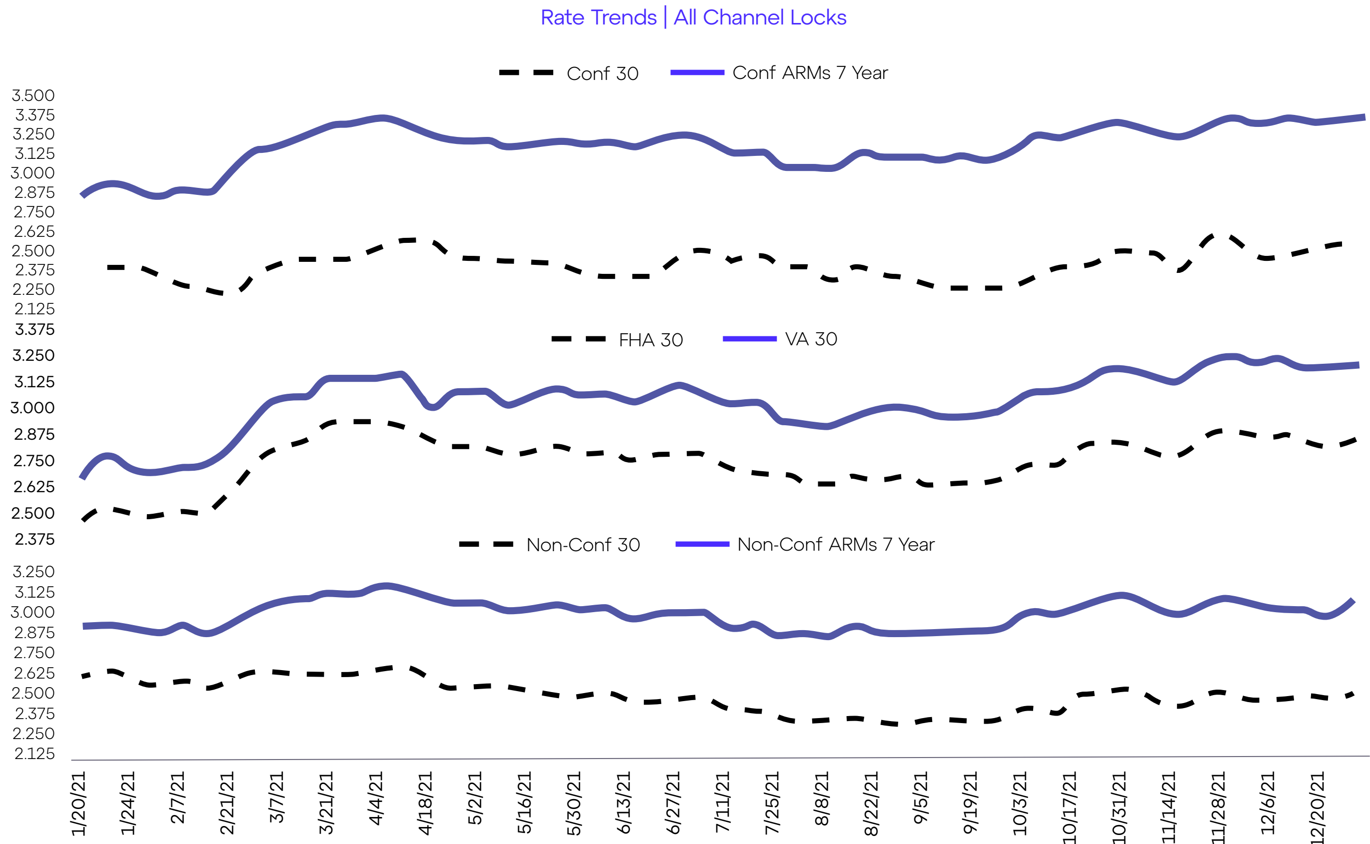
Lenders should expect some increased volatility as these various factors weigh on the financial markets and the economic recovery already under way continues forward. Despite

Figure 3: Mortgage Lending Volume/Rate Trends



Source: Curinos Data

Figure 4: Mortgage Rate Trends by Loan Program



Month over month, Conforming 30 year locked rates increased by about 4bp, Non-Conforming 30 year rates increased by 2bp and FHA 30 rates decreased by 1bp. The spread between 30 year and 7 year ARMs narrowed slightly for both Conforming and Non-Conforming products. Additionally, the spread between Conforming 30 and Non-Conforming 30 slightly to just about 30bp.

Source: Curinos Data

these potential headwinds, the path to higher rates and borrowing costs seems almost certain at this point, marking a significant transition away from the ultra-low rate environment and accommodative policies of the past two decades. Lenders will need to be nimble and strategically oriented to thrive in this higher-rate environment, one in which we expect to see increased competitive pricing pressures and lower refinance demand. For example, rising rates may prompt a resurgence in home equity, a product that hasn't received much attention in recent years.

THE BEST-LAID PLANS...

While the base case remains an extended period of excess liquidity, there is currently a high degree of uncertainty in the market. The most likely alternative scenario would involve the Fed unwinding its balance sheet much faster than expected to combat persistently higher inflation. In this scenario, money would leave the system and banks would find themselves back in a race for deposits. While this isn't the base case, it's important that banks have plans at the ready should events on the ground dictate a change in tactics.

A FINAL CHECKLIST AS WE PREPARE FOR RISING RATES

- ❑ Take stock of your market intelligence — which benchmarks and how to use them
- ❑ Understand the value of your customers and develop proactive plans for what you are willing to do to retain them
- ❑ Plan for the expected and the unexpected — multiple scenarios are more important than ever before
- ❑ Communicate, Communicate, Communicate — equip bankers on the front lines with the bank's narrative on rate positioning and key objectives

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