

Will Dodd-Frank shred

Ending the ban on paying interest on demand deposits, coupled with FDIC premium changes, alters the rules. Here are some possible strategic responses

By Jon Gabriel

The final text of the Dodd-Frank Wall Street Reform and Consumer Protection Act spanned over 2,300 pages. Many parts of it will have intended consequences that impact financial institutions and their customers for years to come. And there will be unintended consequences.

Buried 700 pages into the Act is one of the briefest parts—Section 627, Interest-Bearing Transaction Accounts Authorized, which, one year after enactment (July 21, 2011), repeals the prohibition on payment of interest on commercial demand deposit accounts—in place since the Great Depression.

Opinions on the effect of the repeal range from mundane (ways of crediting revenue to business DDA customers have existed for over 20 years, says this school,

so what's the big deal) to major (the profitability of every commercial DDA relationship will be impacted, say these bankers).

Regardless of your camp, ignoring basic marketing strategies and solid analysis will lead

to unintended consequences for your bank. Some will be potentially significant, because the non-interest bearing commercial DDA has been one of, if not *the* most profitable core deposit relationship and fee generator for financial institutions.

Going by the numbers

A review of “classic” commercial DDA profitability analysis (from the financial institution's perspective) pre-Dodd-Frank and what factors will impact this analysis going forward may help banks identify the issues they

the funding playbook?

will be facing a bit less than a year from now (Exhibit 1). This analysis has been simplified (it eliminates overhead allocation and other indirect costs heavily dependent upon assumptions) for the sake of clear argument.

Let's review how some key elements of the "cost of funds" calculation will be impacted by Dodd-Frank:

1. The FDIC premium assessment shifts from being calculated on deposits to a formula calculated on average consolidated assets minus average tangible equity.

2. FDIC insurance coverage, not limited as to amount (or other account relationships), for *non-interest-bearing* transaction accounts has been extended until

EXHIBIT 1

"Classic" Commercial DDA Profitability Analysis

▶ **Average ledger balance**

- Average ledger balance
- average uncollected funds,
- required reserves (currently 10%)
- = net investable funds

▶ **Revenue and direct expenses**

- Gross revenue: customer fees and charges
- direct costs (item charges, postage, courier)
- = net account revenue/(cost)

▶ **Other direct expenses**

- FDIC insurance premiums
- Earnings credit paid to customers
- Sweep account administrative costs (less any spread retained by the financial institution)

▶ **Cost of funds formula**

- (net account revenue – other direct expenses)/net investable funds = cost of funds (before any indirect expense allocations, required profit margin, or overhead)

Dec. 31, 2012, and is no longer optional (unlike the FDIC's Transaction Account Guarantee Program). These balances are subject to FDIC's regular premium schedule and not a separate schedule, as existed under TAGP.

3. FDIC insurance coverage has been permanently raised to \$250,000 per account (subject to its coverage rules) for interest-bearing accounts.

4. The Federal Reserve Board may make changes to Regulation D between now and the effective date of the repeal on paying interest that may affect the reserve requirement computation as part of its implementation of Section 627.

Initial marketing/pricing considerations that your plan could include are shown in Exhibit 2, below. It is dangerous to predict what pricing and competitive pressures will exist

one year from now. But certain recommendations can be made:

1. Focus on cost of funds management. With compliance and operating costs rising, and ways to generate retail fee income (i.e. overdrafts) becoming increasingly problematic, managing cost of funds becomes even more critical.

Determine what specific commercial customer needs are (i.e. remote deposit capture, billpay); what your costs are; and how commercial customers can use earnings credits to offset those service costs. *An interest-bearing account may not be in the long-term best interest of either your customer or your institution.*

2. Watch large bank tactics. The changes to the FDIC premium formula disproportionately affect larger institutions and institutions with a greater proportion of their liabilities raised from borrow-

ings and other wholesale sources. Increasing the cost of non-insured funding options (by now assessing the FDIC premium against them) increases the relative attractiveness of core deposit and commercial DDA relationships.

As a result, these types of institutions could become more formidable competitors for interest-bearing DDA accounts. However, larger institutions typically have large bases of non-interest-bearing DDA and face potential internal "cannibalization." Wholesale-funded institutions may lack the infrastructure to fully support the commercial services that are important adjuncts to the core transaction account. Look for a *measured* response from potential competitors. Do not anticipate, nor start, a price war.

3. Incent higher-balance customers through earnings

EXHIBIT 2

Triple-headed business-checking challenge, and how banks can tackle it

Non-Interest-Bearing Commercial DDA	Interest-Bearing Commercial DDA	Non-Interest-Bearing Commercial DDA with Sweep¹
<p>Challenges <i>How to maintain margin</i> despite increased FDIC assessment (because coverage is applicable to entire account) and mitigate potential loss of balances and/or account relationship to interest-earning products.</p>	<p>Challenges <i>How to price rationally</i> without cannibalizing non-interest-bearing accounts. How to mitigate cost of FDIC assessment. How to attract and retain large-balance customers without coverage or collateral.</p>	<p>Challenges <i>Fully understanding the cost/margin of the product</i>, given that the collateral is now subject to the FDIC premium calculation and determining its viability. Is an interest-bearing product a more attractive proposition?</p>
<p>Strategies <i>Consider "barbell" positioning.</i></p> <p>One, as a primary full cost/analyzed product for smaller balance customers with an earnings credit that is reduced by the pro-rata amount of the FDIC premium charge.</p> <p>Two, for higher-balance customers, position as the fully guaranteed product, with the tradeoff being an earnings credit that can be utilized to offset fees and charges (instead of interest). Consider providing additional products or service levels for the higher-balance customer.</p>	<p>Strategies <i>Consider tiering as an approach to mitigate the potential cannibalization from non-interest-bearing accounts.</i></p> <p>For example, should there be no interest paid on the initial balance tier (with a high minimum balance required to avoid a maintenance fee) so that the direct costs can be recaptured?</p> <p>Does this become a premium product for large-balance business and professional customers?</p> <p>Are earnings credits on this account confusing. Will they become superfluous?</p>	<p>Strategies <i>Consider ways to reduce the fixed cost structure of this product.</i></p> <p>What are the alternative uses for the repo collateral, and are these better uses?</p> <p>FDIC premium cost has to be priced into both the insured account and deducted from the return paid on the repo investment. Should this be accomplished by setting a higher non-interest-bearing insured balance or lower rates on the repo investment, or both?</p> <p>Are term repos a better product?</p> <p><small>¹The sweep account used in this analysis moves collected funds into repurchase agreements of eligible collateral (typically FNMA/FHLMC/GNMA mortgage-backed securities) of the financial institution. While other structures exist (uninsured money market funds, or Eurodollar accounts) they are outside the scope of this article.</small></p>

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credits. The cost of FDIC insurance will now apply to the entire balance in a non-interest bearing DDA, and there will no longer be an option to not have full coverage. However, the overall attractiveness of acquiring and servicing these accounts remains a strong and definite one—especially larger accounts from an “all-in” cost perspective.

Smaller institutions can compete effectively against larger ones for high-value relationships with the risk component eliminated for the depositor. Consider additional services and features to offer as a way for the higher-balance depositor to utilize the earnings credit.

4. Take a hard fresh look at “sweeps.” Collateral-based sweep accounts merit a thorough exami-

nation. Servicing and compliance considerations are not trivial.

Further, the cost of FDIC insurance that will now be applied against those assets can be directly absorbed in basically only two ways, either out of the institution’s spread or out of the depositor’s interest earnings. Will this be a product whose time has now passed?

Finally, every institution should evaluate the use of their collateral—from an interest-rate-risk perspective and from the viewpoint of alternative investment strategies.

5. Take the opportunity for product-line change, if it fits. The introduction of a new product has to be viewed in the context of its impact on the existing product “suite” and the ability of your bank-

ers to properly position it. There may well be a potential opportunity to consolidate some products and use the interest-bearing option as a way to craft more of an “all-in-one” solution for high-value customers. Resist “product proliferation.”

The Banking Act of 1933 prohibited interest on commercial DDA. Legislators created a disincentive for community banks to move funds upstream, away from the community. It was also viewed as a potential way to produce “cost savings” to cover the newly enacted FDIC coverage. Repeal has created similar challenges over 75 years later. ■

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