Perspectives
A publication of the Financial Managers Society

PARADIGM SHIFT IN FIXED-INCOME OFFERINGS

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According to classical economic theory, it is shocking to observe that during a time of relative economic stability, with record stock market levels and significantly robust real estate markets, long-term interest rates on U.S. Treasuries in 2019 have been lower than they were during the worst of the Great Recession.

As monetary policy experiments across the globe take us into new interest rate territory, the consequences for commercial bank franchises must be considered. Although they appear to the casual observer to be equivalent fixed-rate offerings, the value proposition for the bond holder and the conventional bank time deposit holder are strikingly different. While they both have a fixed-income instrument that accrues interest, the liquidity options of these two fixed-income instruments are vastly different. Is this difference inevitable or a choice?

For the bank depositor, there is a penalty for early withdrawal. For many years, institutions were required to disclose "substantial penalty for early withdrawal" for premature redemption of time deposits. While there is a spectrum of early withdrawal structures in commercial banks today, most are still a function of some number of months of interest. It should be obvious that there is nothing optimal or even financially rational about a depositor being charged a penalty based on a random number of months of interest.

Meanwhile, the robust secondary market for bonds provides a very different financial opportunity. Bonds benefit from the regular accrual of interest that deposit accounts receive, but also the potential for appreciation. Appreciation in value drives the value proposition so much that it even becomes plausible that a rational investor could accept negative bond yields if the proposition for even more negative bond yields would ultimately drive up the value and make holding the bond profitable.

To be sure, no rational depositor will ever find profit from "investing" in conventional bank time deposits at negative interest rates. The conventional certificate of deposit allows no comparable gain beyond the interest rate of the certificate. Newly issued CDs become less and less valuable as interest rates fall, with no mitigating variable. This makes the traditional bank term deposit categorically inferior to the rest of the fixed-income sector, which benefits from a secondary market. Therefore, the challenge to the relevance of bank term deposits is obvious.

Yet it is not yet obvious that bankers are prepared to deliver initiative and innovation to address this situation, which is further complicated by the regulatory environment in which they work. Additionally, there are legacy expectations from bank depositors who tend to be skeptical of anything new from banks and bankers.

Is it possible that a new design in bank term deposits that unleashes a portion of the value for depositors as interest rates fall could become viable and even optimal? Bankers need long-term funding. While they can draw upon funding via the bond market, these wholesale funding sources are not franchise enhancing. For example, the wholesale portion of the balance sheet is not credited for a pricing multiple in the M&A environment. So, while wholesale funding can certainly contribute to liquidity and profitability, it is inferior in its ability to gain greater franchise capital valuations.

Conversations with consumers and banking professionals consistently point to the fact that most people are hard-pressed to see the value in traditional bank time deposits, with derogatory terms like "relic" and "dinosaur" often associated with CD offerings. The numbers bear out this sentiment about the category. FDIC data since 1984 (see Figure 1 below) reveals that time deposits as a percentage of domestic deposits:

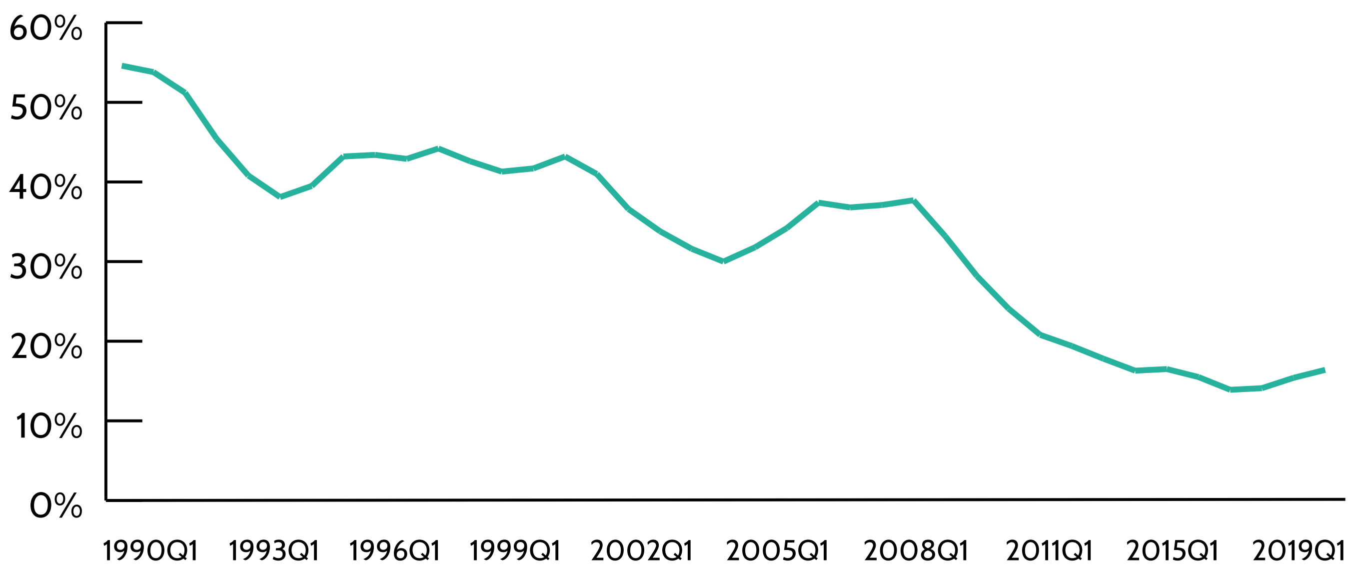
- Hit a high of 55.9% in the third quarter of 1989
- Hit a low of 13.9% in the first quarter of 2017
- Stood at 16.1% in the third quarter of 2019

In theory, the observance of widespread discouragement about the viability of an offering category would produce significant efforts to upgrade those offerings. But even as the numbers show a dramatic decline in the proportion of deposit funding from time deposits, the industry has so far not offered a preferable alternative in any significant way. In fact, time deposits still make up a material portion of the industry balance sheet at over $2 trillion. Where is the industry exploring the alternatives to compete and win properly priced long-term deposits? Is this the only arena of banking that is somehow exempt from improvement?

Although not yet mainstream, some bankers have been structuring time deposit offerings with an approach to early withdrawal that right-sizes the redemption value based on the amount of time to contractual maturity, the coupon of the deposit and the replacement cost to the institution. This market value approach effectively creates a "bond-structured" account. Although it has fixed income and the potential for appreciation like a bond, this type of insured deposit offering does not require any SEC registration.

Financial institutions using this approach have discovered that long-term savers recognize that this new version is universally superior to conventional CDs when the potential penalty is capped to be no greater than the early withdrawal penalty that the institution uses for other certificates of deposit of the same term. By adding this alternative offering alongside the conventional and familiar time deposit structure, banks have created an additional sequence in the sales conversation that helps attract and retain a larger portion of the supply of long-term savings without resorting to price wars. By offering a unique early withdrawal option that still protects the institution, but is more liberal for the depositor, bankers are unleashing value that was previously taken for granted in the conventional approach to time deposits.

FIGURE 1: TIME DEPOSITS AS A PERCENTAGE OF DOMESTIC DEPOSITS



Source: FDIC

With the intensity of competition for deposits today, has the time come for the industry to consider this alternative form of term deposits to provide a better long-term savings vehicle that delivers value like bonds in this era? The bottom line is that rather than attracting funding through wholesale sources that involve intermediaries, institutions can issue more attractive term funding instruments, cut out the intermediaries and produce funding that is eligible for franchise capital valuation multiples (a detailed consideration of this opportunity can be found in my whitepaper The Case for Market Value Time Deposits, which is available in the FMS archives).

This era is producing initiatives in payments and digital lending that incorporate much grander aspirations of disruption than market value time deposits. What then is holding back institutions from broadly embracing an enhanced approach that delivers greater value to all stakeholders today? As competitive pressure for deposits mount and interest rate volatility creates chaos and opportunity, bankers have an opportunity to make a fundamental paradigm shift in how they offer long-term savings. Which innovative "market maker" banks will be among the first to seize this opportunity? What will the adoption rate be and how quickly will consumers recognize the categoric superiority of this approach over the conventional standard for bank term deposits?

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