

# COPING WITH RISING RATES

Financial institutions face a margin squeeze if interest rates start to rise as predicted. One defensive measure is a rewards-based checking product.

BY JEREMY FOSTER

**M**any financial institutions could see their margins squeezed if rates rise soon. Fortunately, a surprisingly sellable solution can help.

In a rising rate environment, banks have often relied on products such as certificates of deposit (CDs) to ease the transition. However, CDs are only a short-term hedge against rapid rate increases, after which they promptly reprice. They can also be a tough sell for consumers who are reluctant to lock their money up for months or years, especially if they think interest rates are on the way up.





Rewards-based checking products offer a better solution. Their value for banks increases in a higher-rate environment, and they become more appealing to consumers as rates rise. Research has shown that rewards checking accounts can lead to longer-term, more profitable relationships with account holders. Rewards checking can also generate noninterest income and benefit banks in any interest rate environment.

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### The trouble with rising rates

Predictions about the future rate environment vary. However, the consensus is that there will be a long, slow increase. Both market expectations and comments from the Federal Reserve chairperson Janet Yellen suggest that the increase will likely be very gradual over the next few years.

Whenever rates do go up, financial institutions will see their interest costs rise, which will likely squeeze some institutions' margins. To manage that squeeze, banks have traditionally turned to promoting products such as CDs. In a rising rate environment, CDs can lock customers in at lower rates for a period of time, so banks don't see their interest costs increase all at once.

Yet, over the long term, CDs aren't an ideal solution, and a long, slow increase in rates creates exactly the wrong environment for CDs.

Why? Eventually, CD terms expire, and consumers move to products paying the prevailing higher rate. CDs can also be a tough sell. Consumers, especially in a still-volatile economy, are wary of locking up their spare cash in a financial product for months or years.

When rates rise, consumers often don't want to settle for today's rate, when it's likely to be higher tomorrow. As a result, banks may overpay for CDs and gain minimal protection in exchange.

### Rewards-based checking

Rewards-based checking solutions may provide a more attractive alternative for managing rising rates.

Rates on these products are tiered and based on qualification criteria. Because not every account holder will meet the criteria, and balances above a certain threshold earn a lower rate, the institution's cost of funds does not increase nearly as quickly as the market-driven promotional rate. This results in a nice cost of funds discount that institutions don't get with CDs.

For example, in 2014, the median nationwide promotional rate for a brand of high-yield, rewards-based checking accounts was 2.0 percent across nearly 600 clients. However, the median cost of funds for these financial institutions was just 0.98 percent, resulting in a cost of funds discount of 51.0 percent (102 basis points) versus the promoted rate. By contrast, if a CD promises 3.7 percent annual percentage yield (APY), then the cost of funds for the institution is exactly 3.7 percent APY.

If the rewards-based checking product is structured correctly, the cost of funds discount stays fairly stable as a percentage, meaning the total savings versus the alternative funding source dramatically increases as rates rise. A 51 percent discount on a rate of 4 percent is greater than a 51 percent discount on a rate of 2 percent.

### Benefits beyond rates

What's more, rewards-based checking accounts offer banks benefits that have nothing to do with interest rates. The accounts grow a bank's core deposits, providing the institution with a stable source of funds for lending. And they cultivate long-term relationships with customers, who may go on to use other bank products, such as auto loans and

## What Is a Rewards Checking Account?

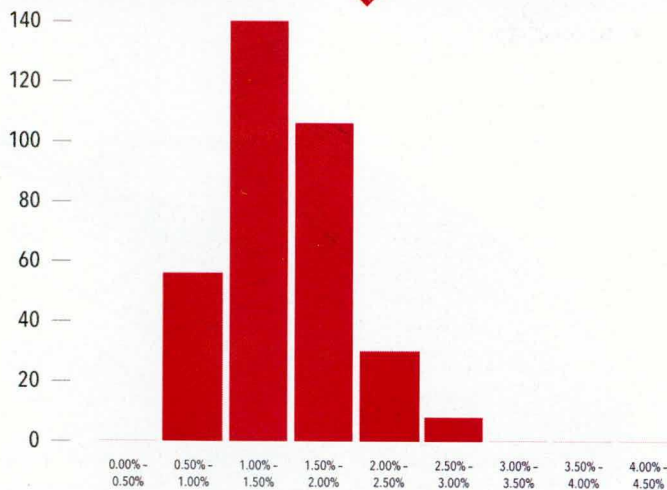
According to Ken Tumin of DepositAccounts.com, the basic reward checking account is a free checking account with no monthly service charges. "You are rewarded with a high interest rate if you meet monthly requirements. Most also reward you with ATM fee reimbursements if you use ATMs at other banks. Below are the typical rewards:

- "Some top rate (say, 2.50 percent) for balances up to a cap (say, \$25,000).
- "Much lower rate (say, 0.25 percent) for the portion of the balance over the cap.

- "Tiny base rate if requirements are not met (say, 0.05 percent).
- "ATM fee refunds up to a certain limit per month.
- "The typical monthly requirements include: (1) 10 to 15 debit card purchases, (2) At least one direct deposit or ACH transaction, (3) Receiving electronic statements.

"There are sometimes additional requirements such as logging into online banking at least once a month or performing online bill payments."

## Cost of Funds



The graphs illustrate the distribution of BancVue's clients offering a rewards-checking product with a specific promoted rate (as of March 2014) vs. the distribution of actual cost of funds.

mortgages. Our company's data shows that the average lifetime value of a traditional free checking account to a financial institution is just \$576; for a rewards-based account, it's \$2,192.

Finally, rewards-based checking accounts, especially as compared to CDs, are more attractive to consumers. They can even be used as an incentive for new customers, especially, millennials, to switch banks.

According to our research, nearly one in two U.S. adults (45 percent) would switch banks to earn higher interest rates. Additionally, 67 percent of millennials say rewards are a very important or important factor when choosing a bank.

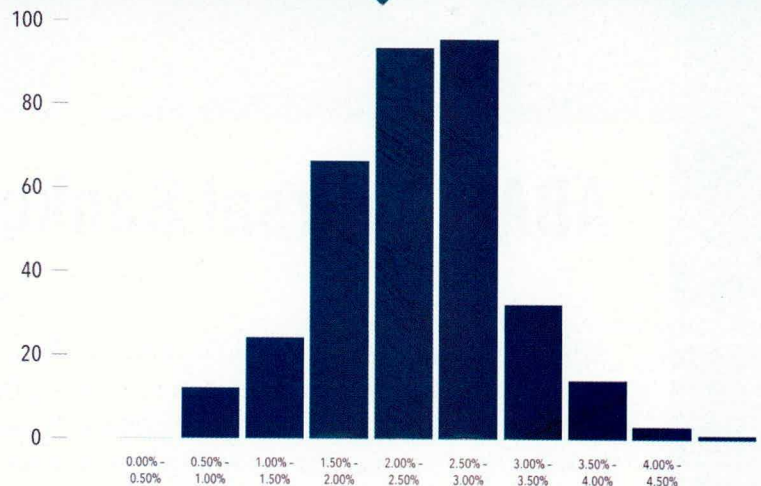
**Rewards-based checking accounts offer banks benefits that have nothing to do with interest rates.**

### Partner effectively

The key to making all of this work lies in structuring the product correctly. The benefits of a small reduction in the cost of funds often outweigh the expense of outside advice, so many financial institutions opt to partner with a third-party provider for assistance with this. The right partner can harness data from multiple institutions and use their experience in different rate environments to help banks get the most out of a rewards-checking product, in the most cost-effective way possible.

Third-party providers can deliver insight into product design and financial engineering to make sure the checking product's rates are set up for maximum benefit. Some of these partners can provide hands-on consumer acquisition help, as well as effective marketing materials.

## Promoted Rate



It's not clear when rates will start rising again. What is clear is that rewards-based checking products can give banks an organic, consumer-friendly hedge against rising rates, as well as a competitive advantage. Whether rates rise in the near future or over the long term, institutions should take steps now to start adopting products that will benefit their business whatever the rate environment. ■

### ABOUT THE AUTHOR

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