FINDING THE SILVER BULLET FOR MARGIN COMPRESSION

2nd edition

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KASASA®

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Post-recovery growth isn't as simple as it looks.

AUTHOR'S NOTE:

In the first edition of this paper, I addressed concerns that community financial institutions had during a protracted post-financial-crisis era. Our industry has left "crisis-response mode," but that does not mean we have returned to business as normal. This edition of the paper includes many of my original points supported by updated stats and an expanded approach to dealing with today's version of margin compression. All stats were updated and verified by Kasasa Analytics as of Q2 2018 — methodology available upon request.

THE FIRST ACRONYM IN BANKING

We all received pretty much the same lecture on the first day of banking school, and it started with the professor writing three large letters on the freshly-cleaned blackboard: C. O. F.

For good reason. Without a sharp eye on cost of funds (COF), banks and credit unions can expose themselves to interest rate risk (among many other pitfalls), with likely detrimental long-term effects. If the 2008 financial crisis taught us anything, it's that net interest margins can compress quickly — and stay compressed much longer than anyone expects, or most models predict. These periods of margin compression revealed how little control we have over our return on earning assets versus market forces. That said, there remains significant opportunity on the deposit side that will ultimately enable greater control of that critical margin.

Unfortunately, COF will always fall short when assessing the true cost for the most common deposit products in a bank or credit union today: checking accounts. These are the core component of any consumer's relationship with their primary financial institution (FI), and the most likely means for attracting new relationships, which are vital for long-term sustainability.

To illustrate, a group of qualification-based, high-interest checking accounts at one of our institutions has a median of $8.57 in monthly interest expense, or a COF of 0.81%. That's high enough to send any CFO running the opposite direction. But those same accounts generate a median of $10.07 in monthly net non-interest income (NII). A complete examination reveals these accounts generate $33.16 in median marginal profit per account (monthly).

Clearly, basing strategic funding decisions on COF alone is like driving down the highway with blinders on, leaving you in danger of making a costly mistake.

A NEW ACRONYM — AND A NEW REVENUE STREAM

Cost of funds works well for many deposit products like savings, money markets, and CDs because there's little non-interest expense or income in these accounts. But what about transaction accounts? Many may carry an interest expense, for which COF adequately accounts. Yet those same accounts also have non-interest expenses and generate non-interest income, which is easily buried in the balance sheet and not properly associated with these deposits.

A NOTE ON ACCOUNTING FOR FIXED EXPENSES

Many are tempted to allocate fixed expenses to deposit products or even individual accounts. Ultimately, this will lead to bad decision-making. The electricity bill won't be affected by taking on one more CD. And one new account holder will have no impact on the number of hours your CSR team works. That's not to say overhead costs are irrelevant — they must be planned, reported, and managed. But accounting for them as a function of each dollar on deposit heaps non-marginal expenses on marginal accounts or deposits. As such, they have no place in the net cost equation for deposit products.

Consider a free checking account; while it has a 0% cost of funds, there are a number of marginal expenses that must be considered — processing checks, sending statements (especially if they're paper), core fees — along with whatever club account features or free toasters you may add in an attempt to differentiate. On the flip side, there are sources of non-interest income, mostly debit card interchange and overdraft revenue. When you look at this whole picture —

Cost of deposits = (non-interest income) - (interest expense + non-interest expense)

interest expense, non-interest expense, and non-interest revenue — you are now looking beyond COF, and seeing a holistic view of the under-reported (and grossly under-utilized) metric referred to as cost of deposits (COD).

A lot of revenue and expense flows through non-interest-bearing checking accounts that never impacts the 0% COF. Unfortunately for many institutions, there is little visibility to these numbers as a function of the individual account type, because most (if not all) of these sources are reported and tracked en masse across the entire deposit suite. This makes it virtually impossible to assign marginal expenses and revenues to individual product types, and can ultimately lead to poor strategic decisions.

WE CAN DO BETTER THAN COF

Transaction accounts are relatively new compared to the long history of banking. Overdraft and interchange revenues are even newer. Accurately measuring these factors into cost of deposits just hasn't become mainstream — yet. As we find ourselves in the midst of historic times in banking, now is the time to change that.

Today, the Fed funds rate appears to be on a steady upward trajectory. Unfortunately, lethargic loan demand leaves many community financial institutions facing a unique type of compression — the result of understandable hesitancy to adjust loans rates up for fear of losing business, while deposit products are commanding higher rates.

Typically, our industry would consider the following options in response to this compression:

- **Increase loan rates** – Regrettably, the continued challenging loan market makes this next to impossible, except for institutions who find ways to compete on something other than rate.
- **Decrease deposit rates** – While many financial institutions have left their deposit rates untouched from historic lows, this is simply postponing the inevitable. As the Fed funds rate rises, it will eventually force upward repricing of all deposits. Down isn't an option.
- **Decrease non-interest expense** – Despite the economic recovery, few financial institutions have loosened their belts beyond the absolute minimum — any more cost cutting is likely to handicap growth.
- **Increase non-interest revenue** – Traditionally, this has meant new and higher fees or other strategies that draw intense consumer ire. But it doesn't have to be that way.

If we continue looking through COF blinders, the only conclusion is to raise loan rates and hope that your competition quickly follows suit. That's clearly not a desirable or winning strategy while loan demand remains less than aggressive. So let's examine some non-traditional means to increase non-interest revenue.

USING COD TO POSITION YOUR FI FOR GROWTH

Through the holistic cost of deposit (COD) lens, we accurately allocate the non-interest expenses and revenues to the accounts generating them. As a result, the true value of transaction accounts as a lower cost/higher margin source of funding becomes apparent. At this pivotal turning point, we realize the "liabilities" of certain deposit accounts are actually outweighed by their revenue streams. With all data points exposed, the strategy for maximizing that revenue, and attracting the most valuable account holders becomes more clear.

An increasingly popular method to do just that has emerged over the last decade: reward-based checking accounts. They are attractive to consumers because they are not only free, which consumers demand, but include the potential to earn rewards, such as high interest. The attraction for banks and credit unions has also been validated.

On the surface, reward checking can look like an unjustifiable expense — increasing your liability and giving little in return. This appearance is deceiving and COD helps to unmask it. First off, profitability per account is much higher than the standard "free" checking account most institutions rely on.

Median monthly profit-per-account:

- $33.16 for reward checking
- $20.71 for standard free checking

The impact of this success in profit-per-account is magnified by the ability reward checking accounts have to attract new account holders. Institutions launching Kasasa reward accounts saw an average 50% increase in annual account openings in the first year of Kasasa compared to the year prior.

As for COD, again, no matter the platform, reward-based accounts have been proven to deliver the best-case scenario — increasing revenue while decreasing expenses. Two examples are Kasasa Cash® and Kasasa

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Cash Back®, which are nationally branded reward checking accounts, and therefore have performance metrics from more than 700 community financial institutions (CFIs).

- Kasasa Cash Back accounts generate 81% more NII compared to Free Checking.
- Kasasa Cash accounts generate 16.5% more NII compared to Free Checking.
- Kasasa Cash accounts have on average 2.5 times higher e-statement adoption when compared to Free Checking.

Most importantly, the median COD of these accounts is as follows:

- Kasasa Cash is -0.27%.
- Kasasa CashBack is -8.34%

Where COD appears as a negative value, it indicates the opposite of cost, or in plain terms, profit margin, net of interest and non-interest expense, before the deposits are invested or loaned. The bottom line... is your bottom line. The holistic COD approach exposes the potential to add millions of dollars in direct income to your institution.

Combined with the profit margins on each account before reinvesting the deposits, it's clear to see (thanks to a COD perspective) how high-yield checking accounts can generate significant revenue while attracting engaged consumers with rewards your competition cannot match.

IMPROVED POSITION FOR A RISING RATE ENVIRONMENT

The Fed raised rates three times in 2017 and unless an unforeseen setback occurs, will maintain a similar pace for the near future. Fully understanding what this rate trajectory will mean for institution-wide COF, net interest margin, and ultimately income can be very difficult.

It's tempting to find solace in historic numbers. During our most recent rising rate environment, as Fed funds skyrocketed from 1.00% to 5.25%*, the interest margin across the industry stayed virtually flat (from 3.50% to 3.34% during the same period**). While COF was on the rise, reinvestment rates were also rising, primarily due to a firmer lending market and more abundant investment options. Today, some are betting these previous behaviors are solid indicators for future expectations. But many of us don't like those odds — for a very good reason.

Demand for funding has rallied somewhat, but the changes in regulatory requirements and scrutiny may suppress the available investment options that fueled reinvestment rates in years past. Changes in Washington have boosted confidence in many sectors of the economy, but continued uncertainty means increased rates won't solve current margin compression issues; at best, they will shift the pressure elsewhere on the balance sheet, and at worst, they will complicate things further. In the end, capitalizing on lowest overall COD better positions every institution in this (and any) environment.

LOWER COSTS WITH ADDED REVENUE

Of course, nothing is ever as simple as one measurement, like COD. Focusing on the benefits of low-cost deposits, for example, could lead to the extreme conclusion of funding your entire deposit portfolio with free checking. After all, free checking is typically the lowest COD product in any financial institution. But this is a fundamentally flawed conclusion. The extraordinarily high attrition rate and extraordinarily low life expectancy of free checking begin to cancel out

PUTTING A FRESH EDGE ON YOUR LENDING STRATEGY

As I've mentioned, community financial institutions are facing margin compression due to the rise in funding costs and a competitive loans market. In a lending space dominated by interest rates as the deciding factor for consumers, it looks untenable for anyone to push theirs up first.

If it were possible to compete on something other than rates — that would create a valuable edge that many institutions desire. For Kasasa clients this edge has come in the form of a new type of loan: the Kasasa Loan™. This loan allows borrowers to pay ahead to reduce debt, and then take that extra money back if they need it. We call it a take-back™.

In our research, 87% of consumers prefer the Kasasa Loan to other conventional loans at price parity. The 13% who didn't prefer it, didn't need a loan in first place. And that demand is just in the primary loans market. We also learned that 98% of consumers would refinance existing debt at the same rate to get a Kasasa Loan.

*https://fred.stlouisfed.org/series/FEDFUNDS
**https://fred.stlouisfed.org/series/USNIM

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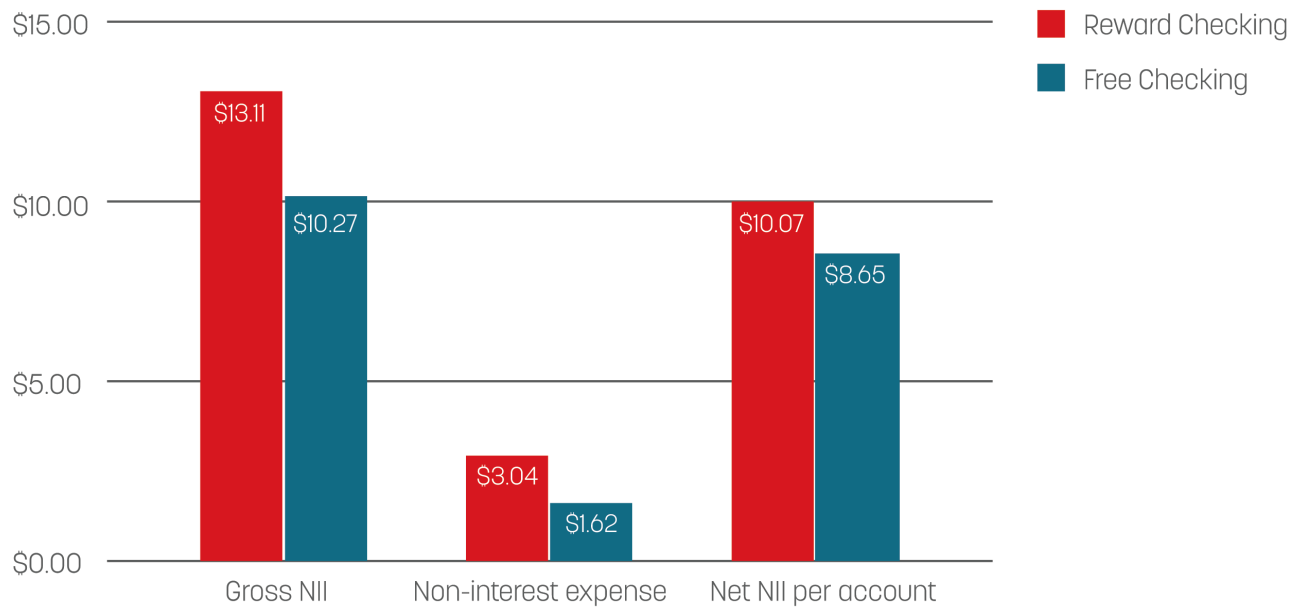
any COD advantage it has. Additionally, the sheer volume of account holders necessary to fund a significant portion of your deposit portfolio with a commodity like free checking would be impossible to obtain.

Reward checking accounts are a different story altogether. While they're an exceptionally low-cost deposit source, cost only scratches the surface of reward checking benefits. Inspecting their full impact reveals key performance advantages that attract younger consumers, driving more non-interest income, netting more wallet share, costing less to acquire, and remaining more loyal over a longer period of time.

Once exposed to the world without COF blinders, it is clear to see what looked like a 0.81% cost of funds is better represented as a -0.27% cost of deposit (or as favorable as -8.34% depending on account type). This illuminates the true value of high-yield checking accounts (a significant profit margin before the deposits are invested or loaned), which is magnified in periods of margin compression. For this reason, many community financial institutions are making low COD transaction deposits like Kasasa a crucial and expanding part of their deposit portfolio. Their present and future bottom lines are benefitting as a result.

Non-interest income and non-interest expense - monthly median



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Profit - monthly median