The battle for deposits

Your bank needs you
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Banks want more retail funding. Easier said than done

THE humble deposit is back. Thanks to the seizure in the wholesale markets, which provided many banks with the money they needed to finance rapid growth during the boom, retail funding is again in heavy demand. In fact, deposits are not perfect either: they too can suddenly evaporate (just ask Northern Rock) and they suffer from a maturity mismatch with long-term assets such as mortgages. But that is tomorrow's headache. “Banks have rediscovered retail as a funding source,” says Dick Harryvan, the boss of ING Direct, a leading internet bank.

However, wanting more deposits is very different from winning them, let alone keeping them. The obvious way to attract new business is to jack up savings rates. Banks are certainly being more lavish than in the past. When interest rates last stood at 5% in Britain, in late 2006, the top savings rates on offer were more than one percentage point lower than today.

Many of the higher rates are being dangled by cost-effective internet operations. Kaupthing and Landsbanki, two Icelandic banks that have been trying to increase their deposit-to-loan ratios since a liquidity scare in 2006, have energetic online savings arms. For such smaller banks, even modest inflows of new deposits can make a big difference.

It is more difficult to make a substantial difference to the size of deposit bases if they are already well-developed. The back book of existing customers presents a particularly thorny problem. Allowing everyone to enjoy higher rates means cannibalising your own profits. Reserving the best rates for new customers either irritates core depositors or invites them to try and game the system. One simple savers' tactic vexing the banks is to withdraw money and then to re-deposit it in order to claim the higher rate.

Even if banks are successful in bringing new money in, two larger questions remain. The first is whether it will stay. The deposit business is largely built on the laziness of customers who keep their money in accounts no matter what the rate. Those who respond to higher rates are also the likeliest to move if a better offer comes along. ING Direct ran into this problem in Britain before the credit crisis, when a failure to keep pace with rates of other providers led to an exodus of disgruntled depositors. It now deliberately targets less rate-sensitive customers.
The second question is how much money banks can make if they are having to compete so hard to entice savers. There are ways to offset the higher costs of deposits. Some retail banks require depositors to put equal amounts of money into other, more profitable, products. Others are looking at structured accounts, where the payouts are linked to the performance of equity indices and where risks can be hedged. But such products are definitely not for the mass market: they may in fact be a route into deposit-taking for the investment banks themselves.

The shape of the yield curve (the difference between long- and short-term interest rates) also makes a difference. ING Direct announced a sharp increase in its interest margin when it released first-quarter results on May 14th, thanks largely to the recent cuts in short-term American interest rates.

But in Europe the yield curve remains inverted (see chart), which drags down profits. Mr Harryvan reckons that the start-up costs for ING Direct would be around €2 billion ($3.1 billion) in today’s interest-rate environment, almost three times the actual figure five years ago. Deposits may be back in fashion, but they are not for the faddish.