Hearing the "D" word again

"Disintermediation," that is. Banks debate putting the brakes on investment sales to maintain deposits

In the mid 1980s, as banking institutions were just beginning to offer alternative investment products such as mutual funds and annuities, internal debates raged in some banks about the business sense of cannibalizing deposits to earn fee income. The traditionalist banker would argue that the bank was "shooting itself in the foot" by selling investments.

By the early 1990s, with flagging loan demand and growing consumer interest in mutual funds and annuities, many banks had embraced retail investment sales and looked to broaden customer relationships, trying to capture a larger share of the customer's financial services wallet. Most bankers stopped using the "D" word, and some banks even stopped tracking the extent to which investment sales disintermediated deposits. But today many banks want to maintain or grow their deposit base again, and some banking executives are again questioning whether investment sales are hurting branch deposit objectives.

Recently we updated the studies we conducted in the early 1990s of the extent to which investment sales disintermediate deposits. We used data from two of our recent studies, The *1996 Kehrer-Alliance Capital Bank Investment Program Benchmarking Study*, and the *1997 Consumer Bankers Association Bank Investment Products Study*. This year 67 banks, which account for 46% of all bank investment sales, participated in both these studies. The study participants were equally divided among community banks, supercommunity banks, regionals, and superregional/money center institutions.

Highlights of the combined, updated study, *The Disintermediation of Bank Deposits by Investment Sales* comprises the rest of this article.

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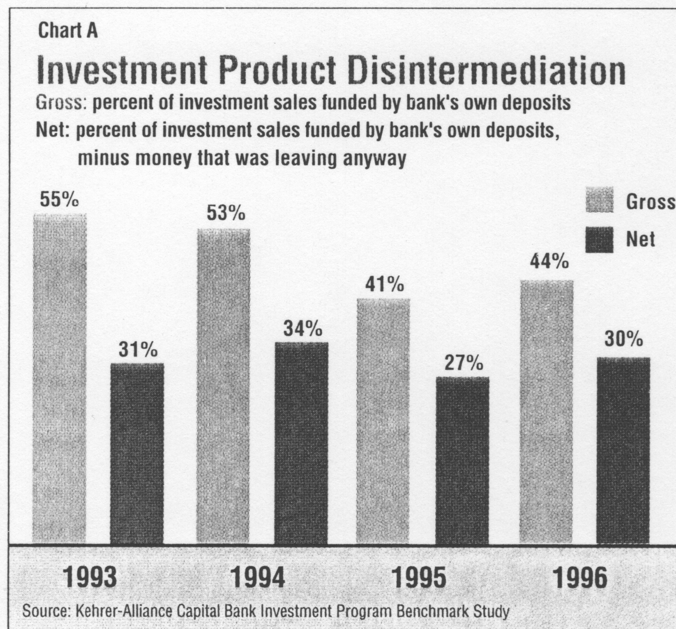
Disintermediation has declined

The percent of bank investment sales funded by a bank's domestic deposits has fallen over the past decade. During the late 1980s, banks typically reported that 60% to 80% of their retail investment sales were paid for out of the bank's own deposits. But banks participating in the benchmarking study have reported disintermediation rates below 50% in each of the past two years (Chart A). While the disintermediation rate increased slightly on average in the 72 banks participating in this year's benchmarking study, still only 44% of the funds invested in mutual funds and annuities through banks was drawn on the bank itself.



Source: Kehrer-Alliance Capital Bank Investment Program Benchmark Study

This decline in deposit cannibalization appears to be the result of the maturation of bank retail investment programs and the shift from fixed annuities (which compete more directly with CDs) to securities.

As investment programs mature, they rely less on referrals and more on building relationships with customers that result in repeat investments. These investments tend to be smaller than the customer's initial investment at the bank, and are often funded out of new savings rather than repositioning existing assets held in deposit accounts at the bank.

Net disintermediation even lower

In measuring the extent to which sales of alternative investments cannibalize deposits, it is useful to distinguish between gross disintermediation and net disintermediation. Gross disintermediation is the percent of alternative investment sales funded by the bank's own deposits. Net disintermediation subtracts the money that would have left anyway in search of an alternative investment.

Some banks have tried to quantify this distinction. They ask their investment customers whether they were shopping for an alternative investment when the bank sold them one. This kind of survey is similar to post-election polls when reporters ask voters why they voted the way they did. While the methodology is not perfect (people sometimes tell you what they think

you want to hear), these surveys do provide a broad picture of consumer behavior. What these banks have found is that as many as two-thirds of the customers who used domestic deposits to buy an alternative investment say they were planning on taking that money out of the bank to buy a mutual fund or annuity anyway.

Other banks monitoring the sources of funds used to purchase investments include those that have sales compensation plans that pay higher incentives for sales that are funded by "foreign" funds. These banks tend not to count money that was leaving anyway in computing sales compensation.

The benchmarking studies cited earlier also ascertained the amount of money that was leaving anyway from the banks that track it. For example, in 1996 these banks reported that 32% of the disintermediated funds would have left anyway to invest in mutual funds or annuities. That means that in the typical bank's alternative investment program, only 30% of the funds customers used to purchase alternative investments would have remained deposited at the bank if the bank did not sell mutual funds or annuities (Chart A).

Most banks actively convert CDs

More than half of the banks participating in the CBA study actively seek to convert their certificates of deposit into noninsured investment sales. The number of banks seeking to convert CDs has fluctuated year by year since 1993, probably reflecting fluctuations in loan demand.

What kind of success do banks have in converting CDs to consumer investments? In 1996, active solicitors converted 14% of maturing CDs to noninsured investments, about the same as in 1994, but fewer than last year.

Mutual funds were the most popular choice for converted CD money for the first time since 1993 (Chart B, page 72). Fifty-six percent of the CDs that were converted into consumer investments were invested in mutual funds, still somewhat below 1993, which remains the high water mark for most indices of mutual fund sales through banks. Only about one out of four CD conversions was invested in fixed annuities, the lowest level since the CBA has been tracking this statistic.

Retail investments more profitable?

Is the bank better off or worse off when a customer transfers money out of a CD to invest in an annuity or mutual fund? This is a very complex issue. The bank earns a net interest margin every year that the customer maintains the CD. But the bank earns a large (generally one-time) fee when its investment subsidiary sells an alternative investment. Whether the bank makes more money by retaining the CD depends on the net interest margin, the rollover rate on CDs, and the factor used to estimate the present value of those future CD earnings.

In our latest disintermediation study, we examine the income earned by CDs with various net interest margins, estimating the present expected value of the margins earned on the CDs. That is, we calculate the present value of the future stream of net interest margins

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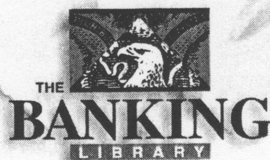

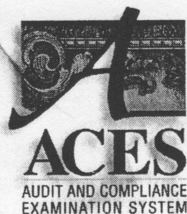

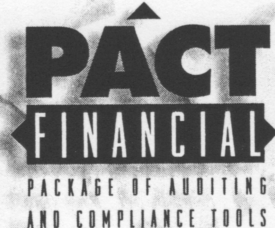

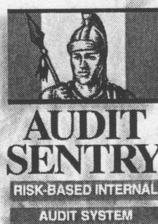

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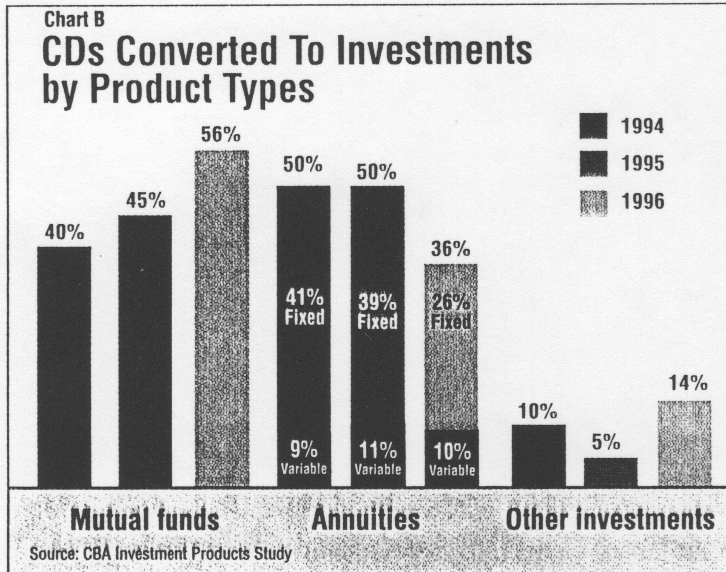
earned on the CDs, taking into account the CDs' rollover rates. Then we compare today's value of that revenue stream from a CD to the commission revenue from a mutual fund or annuity sale.

We found that the present expected value of the net interest margin on short-term CDs or CDs with very small spreads is much less than the revenue that can be earned from selling an annuity or mutual fund. For example, the present expected value of spread income from CDs with less than 100 basis points in net interest margin is never as high as an annuity commission of 6%, no matter what the term of the CD. CDs with 100 basis points of net interest margin need to have terms of ten years to provide as much revenue as an annuity sale. And one-year CDs with a net interest margin of 125 basis points do not provide as much revenue as an annuity sale.



Of course, the higher the net interest margin and the longer the term of the CD, the more revenue it provides. And low discount rates—we used 15% to discount future cash flows—would increase the present expected value of the spread income from the CD.

But clearly the revenue from an investment sale is attractive to a bank relative to short-term CDs especially when spreads are compressed.

Meeting customer needs

But whichever option provides more income, banks need to meet the customer's financial services needs. And it is clear that many customers need to include alternative investments in their savings plan in order to meet their goals for college, retirement, or other long-term objectives. By meeting those needs, banks can deepen customer relationships and build balanced sources of income into the next century. *BJ*