NASHVILLE NOTES

Falling rates may surprise by validating digital banks, fintech asset gatherers

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One of the givens among investors is that bank net interest margins slipped a bit in the second quarter. Commercial loan yields eased as 30-day LIBOR declined. New asset originations all else equal were lower than originations that occurred over the prior six months or so given the inversion of the U.S. Treasury and LIBOR/swap curves. Funding costs have not yet fallen per se, although banks have backed off pricing for institutional and large-dollar deposits based upon anecdotal comments I hear.

Inverted yield curves usually do not last too long because the Fed is forced by the market to cut short-term rates. The Fed has all but admitted that it is going to take back one or more of last year’s rate hikes. Once it does banks will start to reduce deposit rates across the board.

Last week the banking units of Ally Financial Inc. and Goldman Sachs Group Inc. jumped the gun and announced nominal reductions in the rate paid on high-yield digital savings by 10 basis points to 2.10% and 2.15%. The rates still tower over the average money market rate for an account with at least $10,000 of 0.36%, up 0.12% over the past year, according to rate data compiled by S&P Global Market Intelligence.

I am sure there are other banks that have trimmed rates on "high" yielding accounts, but the announcement by two of the largest digital banks raises a few interesting questions about their relative competitive position. A similar question is whether fintech asset gatherers such as Wealthfront Inc. and Robinhood Markets Inc. that offer a premium on their deposit and investment accounts will be disadvantaged by having to cut rates.

The short answer seemingly is yes, but I am not sure that is the case.

Their advantage is derived from offering high rates that are combined with easy digital interaction. Lower the rate and the products will not stand out as much compared to what traditional banks offer. Customer acquisition presumably will slow; or, rates will have to be maintained to sustain growth at the cost of profitability. Private equity investors may prefer the latter given that raising additional capital to subsidize operating losses has not been an issue for many money-losing tech companies. For now, a land-grab strategy (i.e., customer acquisition) trumps positive operating cash flow.

Ironically, traditional banks may not take much flak for trimming deposit rates because they never raised them much when the Fed was hiking short-term rates. Deposit rates remain shockingly close to zero for many products. Even Charles Schwab Bank did not raise deposit rates much, while brokerage clients were forced to move funds to a money market in order to obtain a "market" rate. Deposit betas, or the percentage of changes in market rates that banks pass on to their customers, proved to be very low other than during the last couple of hikes because most depositors were indifferent until rates began to approach 2%.

The pricing issue may be an easier proposition for Ally and Goldman's Marcus to digest than for other digital competitors and perhaps traditional commercial banks. Ally primarily originates auto loans and leases. Marcus holds commercial and CRE loans originated elsewhere within Goldman Sachs while efforts to grow Marcus’ consumer loans appears to be gaining momentum. Both can originate loans that entail a reasonable amount of spread over their "high" cost of funds. That may not be the case for other digital asset gatherers, while traditional banks have limited room to reduce deposit rates unless zero is not a lower bound.

Yet, I wonder if the cat is out of the bag among tech-savvy millennials. A slow drip of change in an industry's business model can turn into a torrent as seen among retailers, asset managers, cable providers and virtually every other industry that is not coddled by government.

Although the spread between rates offered by digital banks and traditional banks is poised to narrow with coming Fed rate cuts, maybe it will not matter greatly. Perhaps the stage has been set for widespread adoption of apps and algorithms that will move excess funds that yield nothing to institutions that will pay something even if it is not much.

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