Global Financial
Private Capital

Why Are Bank CD Rates Still Low?

SYNOPSIS

- The Federal Reserve Bank (Fed) raised their interest rate target this week for the third time since December 2015.
- Investors have asked why some rates rise in lockstep with the Fed while others have remained relatively unchanged.
- The reality is that returns on cash investments will likely remain at these levels for many years to come.

A PERPLEXING REACTION

The Federal Reserve Bank (Fed) raised their interest rate target this week for the third time since December 2015, and investors have asked why some rates rise in lockstep with the Fed while others remain relatively unchanged.

More specifically, the cost to borrow money rises every time the Fed raises rates, but interest earned on deposits stays close to zero. For example, mortgage rates move higher immediately after the Fed hikes, but the rate offered on most bank CDs barely moves. To answer this very astute question, we must first understand how a bank operates.

The primary function of a bank is to pool together small amounts of money from several depositors and then make larger loans to fewer borrowers. The way a bank makes money is by paying depositors a rate of return that is less than the interest rate they charge to borrowers, which is referred to as a "spread."

Let's assume that a local bank was offering a 1% deposit rate to customers and a 5% rate on small business loans to collect a 4% spread (5% - 1% = 4%).

For example, if a small business took out a loan for $1 million for 12 months, then the bank will earn 5% from the small business, or $50,000, and pay the depositors 1%, or $10,000. The total profit to the bank is then $40,000 ($50,000 - $10,000 = $40,000).

The rate at which banks loan money is heavily influenced by the Fed, and since they have been raising interest rates, banks are now charging more for loans. This is why mortgage rates and small business loans rise when the Fed hikes.

However, the rate that banks pay for deposits is less influenced by the Fed's target interest rate level and more influenced by the laws of supply and demand.

…income still exists, but finding it requires professional help…

Think of deposits to a bank as raw materials for other types of companies. If a clothing company wants to make more shirts, they must first buy more cotton. Deposits to a bank are identical to cotton to the clothing company in the sense that they must first buy more raw materials (deposits) to create more goods to sell (loans).

If the economy is on fire, then demand for loans rises. Banks can earn more money by making more loans to meet this demand and will compete with other banks to buy more raw materials (deposits). In our example, a bank may increase its deposit rate to 3% from 1% to attract new customers.

However, if the economy is slow, they will offer a lower interest rate because they are not loaning as much money just as the clothing company will buy less cotton during a recession. Here, a bank would reduce the deposit rate since it does not require as many deposits to pool together to sell loans.

Another reason a bank may not offer a higher deposit rate is if its supply of deposits is already high. For example, if the clothing company had so much cotton

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in their warehouse that it far exceeded the amount needed to fulfill all its upcoming orders, it most likely will not buy more cotton until all the excess cotton was used.

This is the reason why banks are not increasing the deposit rate. Thanks to the financial crisis, the Fed flooded banks with billions in excess cash so they would not go under. Since this capital remains in banks to this day, most will not need additional raw materials (deposits) for quite some time.

Simply put, banks are still sitting in so much excess capital from the financial crisis that they do not need additional capital and thus offer next to nothing on deposits.

At some point, banks will need to pay more for deposits to attract new capital in the same manner that our clothing company will need to buy more cotton once it depletes its existing raw materials. The question is when this will happen.

Historically, the early innings in a rising interest rate environment tend to see little movement in the deposit rate because it takes a while for loan demand to rise coming out of a recession.

However, the financial crisis was no normal recession, and since banks have way more cash than during prior recoveries, the supply of excess capital and demand for loans will likely take longer than normal to balance out. addicted to the gains that they ignored the most basic principles of diversification.

IMPLICATIONS FOR INVESTORS

The Fed declared war on seniors and savers in 2008 by dropping interest rates to zero and inundating banks with so much capital that they relied far less on attracting deposits.

Those who require income from investments have since been anxiously waiting for the return of the 5% bank CD, so they can earn income but also sleep at night knowing their nest egg is safe.

The unfortunate reality is that rising interest rates will not end this war overnight. Since banks do not need more capital, returns on bank CDs and other deposits will likely remain low for many years, perhaps even decades to come. This is the bad news.

The good news is that income still exists, but finding it requires professional help because markets are far too sophisticated today for a do-it-yourself investor to generate income safely.

Think about what it took to fix a car back in the 1970s versus today. Back then, a wrench and a basic understanding of an engine could fix most problems. Today, consumers practically need an engineering degree to change the air in the tires. The sophistication has turned cars into computers on wheels, and trained mechanics are now the only ones suited to work on them.

The same applies to income generation. The strategies used by risk-averse investors to pay bills a decade ago can no longer work in the complexity of markets today. Investors now need expertise in the same way we need help when something breaks in our cars.

The bottom line is that it may be a very long time before we see a bank CD rate commensurate to the pre-financial crisis era, but that does not mean it has become impossible to earn income safely in retirement.

Sincerely,

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