

BankThink Banks Should Make It Harder to Withdraw CDs Early

By *Lynn A. David*

There is a very old saying that what goes up must come down. The reverse is also true in regard to current interest rates on certificates of deposit.

On July 1, 2006, the average rate on a six-month CD was 5.54% and on July 1, 2009, the average rate was 0.50%. This represents over a 500-basis-point decrease in 36 months.

In the past 60 days, we have begun to see an increase in interest rates. The question today is how fast and how far will rates increase.

Rapidly increasing rates can have a very significant impact on a bank's asset/liability management, net interest margin and bottom-line profitability.

Many years ago the Federal Reserve eliminated the regulations regarding early-withdrawal penalties on CDs. Today, banks can establish any structure for their early-withdrawal penalty. However, some banks still charge a one-month penalty on a CD of one year or less and a three-month penalty on CDs over one year.

On July 1, 1980, the average rate on a six-month CD was 8.73% and in July 1, 1981 it was 17.40% – over an 800-basis-point increase in 12 months. Can this happen again, but starting at a lower initial interest rate? During this 12-month period, customers were coming to the bank and cashing CDs they had purchased only 30 to 60 days prior because it was cost effective to pay the early-withdrawal penalty and reinvest at a higher interest rate.

Most customers do not ask about a bank's early-withdrawal penalty when purchasing a CD. Therefore, it is not usually a competitive issue among banks.

Banks need to consider the following minimum structure for their early-withdrawal penalty: a three-month penalty on CDs of less than 12 months, a six-month penalty on CDs of 12 to 23 months and a 12-month penalty on CDs issued for 24 months and longer. An alternative would be a penalty equal to 50% of the term of the CD, i.e. 18-month penalty on a 36-month CD.

It should not be easily cost effective to cash any CD prior to maturity.

Existing CD customers should be sent a notice concerning the changes in the early-withdrawal penalty that will become effective when their CD renews.

We all know that controlling a bank's net interest margin is the single most important factor in determining a bank's overall profitability. Adjust your early-withdrawal penalties today.