KLAROS GROUP

Klaros Advisors Insights

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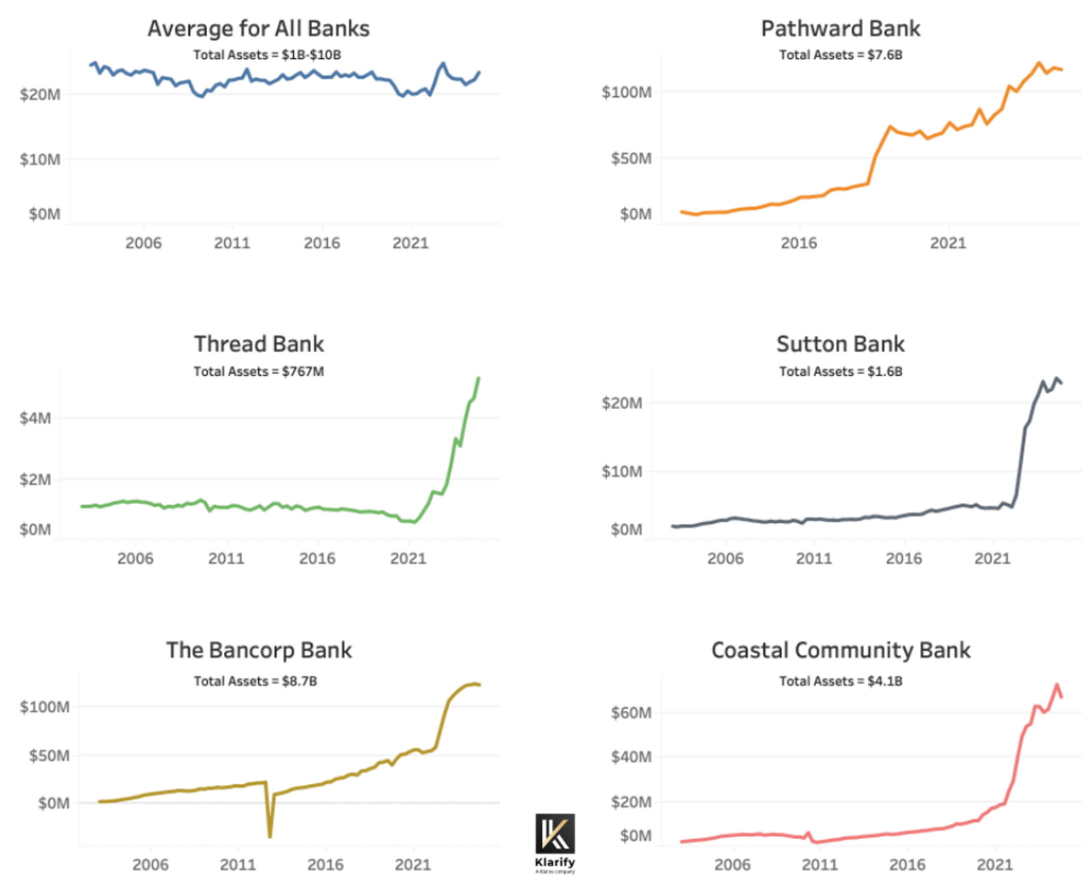
The Klaros Quick Take

Net Interest Income for Top 5 Deposit Focused Partner Banks Compared to All Banks of Similar Size



Conventional wisdom sees partner banking as a way for smaller banks to generate non-interest income through partner fees and interchange. But we've noticed something interesting. As the chart shows, net interest income at scaled partner banks has soared in the last four years, when the trend for all banks under $10B has been one of only modest growth.

To be more precise, these five banks grew net interest income by 131% in the four-year period from end-2020 to end-2024, compared to 14% for all banks between $1B and $10B.

What's going on?

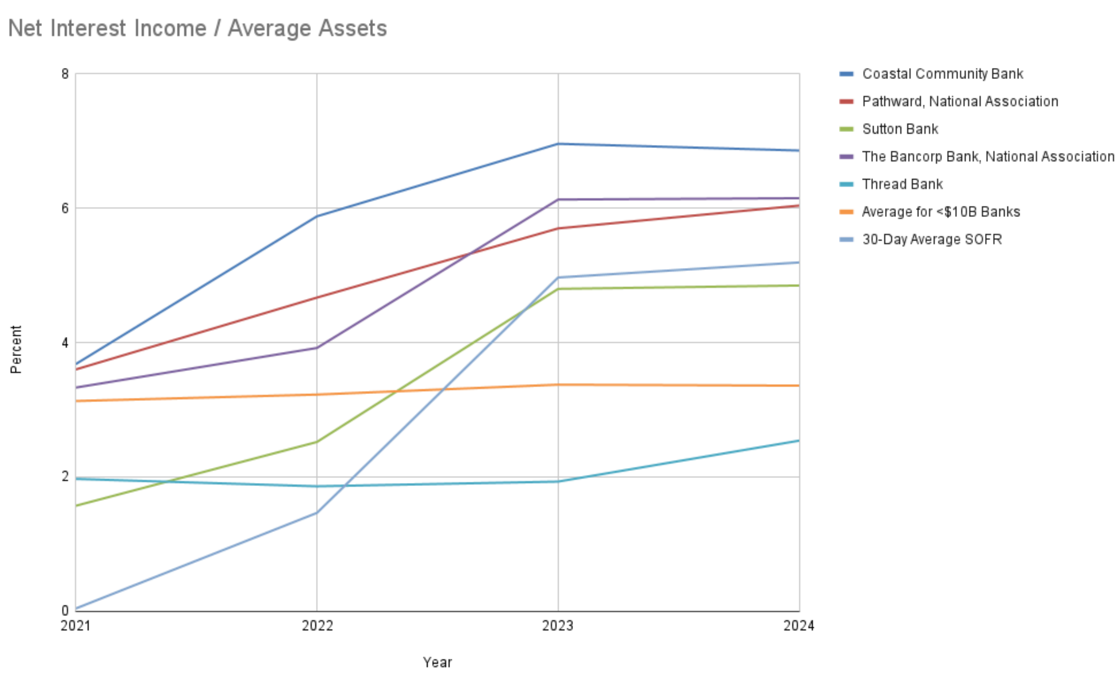
It's easy to come up with plausible theories, none of which are mutually exclusive:

- Partner banks are growing assets, which leads to higher gross net interest income.
- Partner banks are sweeping more money to other banks, which would also lead to higher gross net interest income.
- Partner banks' deposits became more profitable than other deposits as interest rates rose. This could happen because:
    - Program deposits are less sensitive to rising interest rates than the typical deposit base of similarly sized banks.
    - Partners underestimated the importance of negotiating revenue share on deposits in the ZIRP period, giving partner banks a windfall share of the benefits of higher interest rates until contracts could be renegotiated.
- Rising interest rates have caused partner banks to refocus contractual arrangements to prioritize revenue from deposit share

over non-interest revenue when negotiating contracts.
- Some or all partner banks are accounting for the revenue share payments on deposits they make to partners as non-interest expense, which leads to higher net interest income and higher non-interest expense in periods of rising interest rates.
- Partner banks are improving their lending activities, leading to higher interest income.

Let's take the first three of these one by one:

1. **Total Deposits** - Deposit growth accounts for approximately a quarter of the difference. The five banks saw deposits grow by 37%, compared to 7% for the total peer group.
2. **Increased Sweep Activity** - It's hard to assess this from public data. Our sense at Klaros is that scaled partner banks are making somewhat more use of sweep networks than they were four years ago, but not by enough for this to be the most meaningful factor.
3. **Partner Bank Deposit Profitability Increasing as Interest Rates Rise** - The chart below supports the theory that scaled partner banks were able to capture significant benefits from rising interest rates in 2021 and 2022 that similarly sized banks did not. Net interest margin for the five banks increased by about 85% over the period, compared to 6% for the group of similarly sized banks (note that increased sweep activity also results in higher NIM, so this figure is an effective measure of 2 and 3 combined).



Some simple back-of-the-envelope math tells us that these three factors are sufficient to account for pretty much all of the net interest income growth in the period. The other factors listed were plausible theories and may be true for individual banks, but they are not needed to explain this growth.

This data also casts an interesting light on the ongoing debate about brokered deposits. The fact that these scaled partner banks were able to increase both total assets and net interest margin as rates rose provides further evidence that partner bank deposits, taken as a whole, may actually be more stable than typical bank deposits. This is interesting food for thought for the FDIC as it considers whether the Brokered Deposit Rule warrants further modernization.

Klaros in the media:

- Michele Alt spoke with Emily Mason of **Bloomberg** and Steve Cocheo of the **Financial Brand** on fintech's rush toward bank charters
- Adam Shapiro spoke with Gabby Saulsbery of **Banking Dive** on crypto's rush toward bank charters
- Senior advisors Bob Hartheimer and Derek Higginbotham were quoted in **Banking Dive** on the evolving partner bank ecosystem and the future of BaaS

Our top posts on LinkedIn, based on your feedback:

- Adam Shapiro: The dirty work that will drive success in embedded finance
- Michele Alt: I keep answering the same question these days from fintech leaders
- Konrad Alt: A surprising trend in federal banking enforcement

Conferences & events

- Michele Alt spoke with Jason Mikula on all things bank charter-related on the Fintech Business Podcast released on April 30.
- Adam Shapiro spoke on a panel, "Future-Proofing Emerging Technologies with Sound Governance," at the National Fair Housing Alliance's Responsible AI Symposium on April 28th.
- ICYMI, you can catch up with all our Radically Clear episodes here!

Get in touch

As always, if you're facing a challenge or have a topic you'd like to discuss, reach us at hello@klaros.com. We'd love your feedback and thoughts on other topics you'd like us to cover!