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Bank Asset/Liability Management

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New Liquidity Coverage Ratio Creates Community Bank Growth Opportunities

Well-known financial industry publications recently reported that many large U.S. money center banks forced out hundreds of billions of deposit balances during 2015.

Given the banking industry's strong liquidity metrics and today's low national interest rate environment, many bank asset/liability managers have concluded that the discarded deposits were simply unprofitable relationships. However, many industry experts believe that these deposits were driven out as a result of the new regulatory required Liquidity Coverage Ratio (LCR).

Liquidity Coverage Ratio Defined. The LCR was designed under the Basel III agreement as a global banking standard for large banks to meet minimum liquidity levels, while bolstering their ability to survive a 30-day market crisis.

But the devil is in the details of the LCR. The definition of a deposit, specifically a *stable deposit*, has changed. Over the last year the largest international banks have begun the arduous implementation of the LCR requirements. While most community banks have a general awareness of the LCR regulations, it is highly probable that many community banks may never have to comply with the LCR requirements.

However, dissecting the fundamentals of the LCR regulations allows community bank asset/liability managers to gain a perspective of these new liquidity requirements regardless of their financial institutions' asset size.

In This Issue:

Simplifying the LCR Calculations. The objective of the liquidity coverage ratio is to mandate that large financial institutions have sufficient on-balance -sheet liquidity to sustain a significant downturn in the financial and economic environments. LCR requires banks with assets greater than $50 billion to hold high quality liquid assets at a rate equal to at

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least 100% of their potential 30-day deposit outflows. These high quality assets are defined primarily as cash and agency grade bonds which are normally lower-yielding when compared to alternatives.

LCR clearly has the potential to drive down net interest margin in these institutions. Given this stark reality, there is a natural bias for complying institutions to want to lower their 30-day deposit outflows in order to achieve the 100% outflow coverage requirement.

But how do these banks determine 30-day *stress* deposit outflows? The large banks are required to assign potential runoff assumptions for all classes of deposits. Insured retail deposits with multiple relationships and/or checking accounts have significantly lower required outflow assumptions than any other deposit classes. In fact, these deposits are assigned a 3% runoff rate compared to anywhere from 40% to as much as 100% on other types of deposits.

The LCR requirements strongly favor retail checking accounts with less than $250,000 in balances with multiple relationships. These accounts are becoming the new definition of *stable* deposit. The LCR requirement also highly penalizes non-operating commercial deposits and public/municipal deposits.

LCR Implications. Conceptually, many bank asset/liability managers agree that the LCR is a reasonable liquidity measure for larger institutions. By reserving against potential deposit outflows in an economic downturn, the banking system should be able to better sustain systemic liquidity risks.

However, numerous questions remain. Many bank A/L managers are asking, "*How are large banks responding to the LCR? Could their response change when interest rates rise and liquidity pressures mount? How will the consequences of the LCR impact my institution?"*

A Growing Demand for Retail Deposits. Recent communication from Fed officials stated that the liquidity coverage ratio will artificially drive up pricing for the rest of the industry and will likely result in a higher level of competition for retail bank deposits.

For example, JP Morgan Chase had to force out $100 billion in deposits because of the liquidity coverage ratio. Although it is not clear what types of deposits were *forced out*, one must assume it was not retail deposits. It is not too far of a stretch to expect JP Morgan and others to respond accordingly and focus deposit gathering efforts where there is the most economic benefit for the bank.

In the past, many larger institutions have not relied on retail funding as a major source of liquidity. It is just not a core competency that has provided efficiency in terms of scale and growth. Using JP Morgan as a simplified example, the $100 billion in deposits may have likely been a few large account relationships. However, to replace these deposits with *stable* retail deposits would require over 400,000 relationships; and that assumes $250,000 in each relationship.

Where to Focus? As competition intensifies, banks of all sizes are working on strategies to grow their deposit base. From technology improvements to the branch of the future, new creative innovations seem to be announced on a daily basis.

Moreover, industry veterans realize that the most efficient strategy to grow a financial institution's deposit base at the margin is an outright laser focus on gaining a higher market share from the existing customers. There is simply a wealth of opportunity within each bank's current base. It is not uncommon for many retail customers to have as many as six deposit accounts spread over multiple institutions.

What's more, many A/L managers are asking, "*How do we develop a primary relationship with our current and prospective customer base?*"

If your institution is unable to win the primary customer deposit relationship, beware, for your competitors will. Gaining a higher market share of your customer deposit base is not only necessary to grow deposits but mandatory to protect against potential deposit attrition. Accordingly, it is ironic that most community bank deposit strategies and marketing budgets focus on attracting new customers to the bank.

Banks that can gain greater deposit base market share through best-in-class product and customer service will be winners in this new norm.

Better Banking through Analytics. The most sophisticated institutions are personalizing the retail banking experience through big data technology initiatives thereby allowing high-end services that are cost efficient. In addition, they are utilizing analytical models to predict price elasticity of depositors.

Many of these institutions quantify all elements of the customer relationship and use this data to improve service, product offerings, and pricing. What's more, these financial institutions are using this data to communicate regularly and relevantly with their customers. Such strategies are becoming the cornerstone in the effort to gain a greater deposit market share.

At its core, analytics are helping institutions better understand their customer base.

Commercial and Public Fund Opportunities. There has been much discussion surrounding retail opportunities and challenges for community banks. Perhaps the most feasible growth option for the community banking sector may, in fact, be in the commercial and public fund sectors.

Both commercial savings accounts and public funds are highly punitive for complying LCR banks. In fact, Branch Bank & Trust has publicly stated that, "*The LCR will virtually eliminate the willingness of banks to be depositories for public funds.*"

This challenge for larger institutions represents a much-welcomed opportunity for community banks. The scale and opportunities are massive; a few larger commercial and/or public relationships may be able to fund a significant portion of future balance sheet growth.

Obviously, collateral requirements need to be evaluated. However, for all the concerns around the future of the retail sector there is equal opportunity to grow deposits through these channels. If this isn't already a core competency in your bank, it should be an important area to investigate for 2016.

Take *Advantage* of LCR. For the first time this decade, bankers face the prospect of higher funding costs. Liquidity challenges for some are beginning to mount as loan growth is outpacing deposit expansion in many markets.

Developing proactive deposit product and pricing strategies can drive growth while protecting net interest margins. The LCR provides a helpful framework for community banks to learn from the experiences of larger banks, while potentially benefiting from the exemption of overly restrictive policies in certain deposit product sets.

The unintended consequence of ignoring the LCR is higher funding costs, muted growth opportunities, lost market share, and longer-term franchise dilution.

Be proactive. Gather information to help reduce funding costs, grow deposits and build market share.

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