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FEATURE

THE WAR FOR DEPOSITS

WITH RATES ON THE RISE AND LOAN GROWTH ON A STEADY CLIMB, THESE SHOULD BE THE BEST OF TIMES FOR FINANCIAL INSTITUTIONS. BUT AS LIQUIDITY CONCERNS BEGIN TO FESTER, THE HEIGHTENED COMPETITION FOR DEPOSITS THREATENS TO DEVELOP INTO AN ARMS RACE.

"It was the best of times, it was the worst of times…"

While almost anyone who has made it through a high school English class is likely familiar with that immortal opening line from Charles Dickens' 1859 masterpiece *A Tale of Two Cities*, fewer probably know how the passage continues just beyond those ellipses. Specifically, the author goes on to note that the period in question surrounding the French Revolution was also simultaneously "the age of wisdom" and "the age of foolishness."

Despite this seemingly contradictory characterization, it is a description that just might ring true among many community institutions in the current deposit and lending environment. For just as the healthier economy and its accompanying uptick in loan growth are combining to help banks and credit unions once again better resemble the prudent, trusted financial stalwarts they were largely believed to be prior to the Great Recession, the resulting ground-level skirmishes for the deposits needed to fund that ongoing loan growth and maintain adequate liquidity have the potential to tip the scales back toward an age of keeping-up-with-the-Joneses foolishness which, unfortunately, will look all too familiar to those who have been around this block before.

"The banking industry has always been a 'war for deposits' because institutions rise and fall on the flow of deposits," says Robert Perry, a principal in the ALM and Investment Strategy division at ALM First Financial Advisors. "However, today is unique from the standpoint of community institutions, which tend to be smaller in terms of asset size, have higher operating costs relative to revenue and are more likely to have branches in rural locations compared to their non-community counterparts. In this area of the marketplace, the war for deposits is the challenge community institutions face to gain deposit share over non-community institutions, which tend to have a greater share of deposits overall, and in particular, have a greater share of valuable metropolitan deposits. That said, rising funding costs are a bit of a sleeping giant for the banking industry as a whole."

Others may not be ready to declare the current environment a "war" just yet, but they nevertheless can hear the drums beating and smell the gunpowder that may portend a larger-scale conflict to come.

"'War' is probably a little more aggressive than I would characterize it right now," says Tom Hauck, a managing director at ProBank Austin. "There are probably some small battles at this point, but I certainly think that later in the year we could experience some escalation as institutions continue to see loan growth. Particularly for community institutions, there was a lot of liquidity on balance sheets for the past several years, and amid some pretty strong loan demand in 2017 a lot of that has been eaten up. So as we push forward, assuming loan demand remains reasonably strong, institutions are going to have to start growing deposits or look elsewhere if they can't."

> "Particularly for community institutions, the rising cost of funds could be a bit of a ticking time bomb, which is why they should be looking at their deposit stability."
>
> *Robert Perry, Principal – ALM and Investment Strategy, ALM First Financial Advisors*

LIQUID CONCERNS

Indeed, any discussion about a war for deposits starts with the multi-year growth in loan portfolios, and the effect that run-up has had on the liquidity residing on institutions' balance sheets. During a CFO roundtable session at the 2017 FMS Forum in Las Vegas last summer, the wide-ranging discussion continually circled back to concerns about liquidity – regardless of the asset size or region of the institution in question, these heads of finance clearly saw liquidity as a challenge that touched on virtually every aspect of what they were trying to do.

"For institutions experiencing above-average loan growth, that loan growth is often outpacing deposit growth," confirms Matt Pieniazek, president of Darling Consulting Group. "This has contributed over recent years to some very clear reductions in on-balance sheet liquidity levels, resulting in investment portfolios that have been shrinking aggressively as institutions redirect the cash flow to fund the delta between loan and deposit growth."

But for many institutions it's not a question of simply building liquidity back up to where it was – it's about determining where that liquidity level even needs to be these days.

"The biggest challenge is probably the fear of the unknown," says Christine Mills, a managing director of analytics at MountainView Financial Solutions. "Historically, institutions didn't hold a lot of excess liquidity because there's a big cost

WHOLE-HEARTED

As loan portfolios grow and the competition for deposits continues to heat up, some institutions may find it useful to explore an alternative source of liquidity they perhaps haven't considered in quite some time (if ever) – wholesale funding. While for most institutions it remains more of a contingency funding option than a source for everyday liquidity, that may start to change if deposits do indeed dry up.

"In terms of pricing opportunities, institutions have to look at their cash flows and balance sheet structures to determine if they're better off pushing 1-year or 5-year CDs or maybe going after wholesale funds rather than core deposits," says Tom Hauck. "That's the benefit of wholesale funding – you can make a phone call and have quick liquidity, whereas running a CD special is going to take time."

Particularly if they're new to wholesale funding or haven't dipped a toe in the wholesale pool in many years, however, there are a few important things for institutions to keep in mind before taking the plunge.

BE SPECIFIC, BUT NOT TOO RESTRICTIVE

Care should be taken not to make wholesale funding policies unnecessarily restrictive. Have explicit instructions, but provide ALCO with the appropriate flexibility to do its job. Make sure there's a reason and logic for the term structure of your wholesale funding, and be sure to have a clear linkage to the needs of the balance sheet.

UNDERSTAND WHAT WILL CHANGE IN THE CASE OF A LIQUIDITY EVENT

Many unsecured wholesale funding channels are not going to be available in a crisis, and the institution's contingency liquidity plan needs to reflect that.

KEEP THE REGULATORS IN MIND

While many regulators have grown more open-minded about the use of wholesale funding in recent years, they definitely want to see a clear plan with institution-specific assumptions (including an understanding of what happens if those assumptions are wrong) and correlation with other risk management functions.

associated with that. But that changed after the crisis, so now all of these questions have come up and in many cases there's really no right or wrong answer. The guidance is clear about holding marketable, unencumbered liquidity, but less so as to how much. And when a lot of institutions look back on their data from before the crisis, they didn't have a lot of liquidity issues so there isn't a clear example from their own history to reference."

PRICE POINTS

Woven throughout those questions surrounding liquidity is the very fiber at the heart of this war for deposits – just how much is an institution willing to pay to keep its existing depositors and attract new ones? In attempting to balance the desire to grow deposits with the need to manage the pace with which funding costs increase, there are some very important discussions to be had and some crucial decisions to be made.

"The yield curve is so flat and the long end of the curve has not moved up, so institutions have not been able to increase loan offering rates to any degree," Hauck says. "At the same time, however, they're starting to have to pay up for deposits and that's putting pressure on margins, and it's probably going to continue to happen for a while."

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>
> *Matt Pieniazek, President, Darling Consulting Group*

Even if paying up for deposits may seem inevitable, however, few institutions have shown a willingness to fire the first shot in what promises to become a very expensive battle ahead. Because once those costs start to rise, there are going to be some difficult decisions to make.

"In the past year, market rates have gone up 100 basis points, but if you strip away the large institutions, the typical cost of funds at the average community institution has not gone up much at all – they've gotten away with it because of the herd mentality that nobody wanted to be the first out of the gate to raise deposit rates," Pieniazek explains. "But that balancing act is going to get a little bit tougher each time the Fed raises rates, and ultimately the business issue is going to come down to an institution's willingness to accept some deposits leaving – especially when the higher probability is that those deposits that are most rate-sensitive are going to be the ones to leave. On the one hand, if you don't really have a liquidity challenge, then why pay up for hot money? Institutions with tighter liquidity, on the other hand, have a little bit of a different dynamic to work through. How do they attract incremental deposits while minimizing the cost of cannibalizing what they already have? It's a balancing act of growing deposits and managing overall funding costs."

"The primary risk is paying too much for the deposit – it's that simple, really," adds Hauck. "You have to look at the impact to the bottom line. Is the institution raising deposit rates to match competition, or is it raising rates because it really needs to gather those deposits? Some institutions with excess liquidity may not have to match their competitors, so they can actually let some of those deposits run off."

FORECASTING WINNERS AND LOSERS

The institutions that figure out how to best manage that balancing act of growing deposits and managing funding costs will be the ones most likely to come out of this war in a better position than they went into it. But what are the critical considerations they need to be making now, before the fighting gets underway in earnest, in order to emerge victorious?

"Right now, it is important for institutions to review their pricing strategies," Perry believes. "Particularly for community institutions, the rising cost of funds could be a bit of a ticking time bomb, which is why they should be looking at their deposit stability. For institutions with high costs of funds already, hot money, for example, tends to undermine depository franchise value since the value to the depositor stems from the rate paid, so lowering the rate could be a viable strategy should the institution have the liquidity to spare. The deposits could turn out to be stickier than modeled and, if not, they may not be worth the cost anyway."

Regardless of how they approach the deposit questions, however, Hauck says one thing is certain – this is definitely roll-up-the-sleeves time for institutions.

"Since the recession ended, we've seen fairly significant non-maturity deposit growth in a historically low-rate environment," he says. "Institutions haven't had to market their deposit products in order to see deposit growth. That trend is going to have to reverse – they're going to have to be more aggressive in gathering core deposits, instead of just opening up the doors and having the money roll in."

Ultimately, however, while deposit studies, liquidity concerns, marketing plans, and even emerging technologies will all certainly play some role in how an institution chooses to gird itself for the competition for deposits to come, Hauck believes that one of the most effective weapons in this war will be something that community institutions have long valued and long fostered as a key element of their business model.

"The institutions that are gathering deposits are benefiting largely from their relationships, and from having qualified and capable staff who can aggressively go after existing customers for more deposits," he says. "Rate is not necessarily going to be the primary driver of deposit generation going forward – it's going to be those customer relationships." ▪

A LIQUIDITY TO-DO LIST

Given the fluidity of marketplace conditions and the unique challenges facing each individual institution, there's no one standard piece of advice to fully address every liquidity situation. But there are a number of general guidelines most institutions would be wise to observe as they look to avoid getting caught up in a deposit war and instead solidify their liquidity planning for the remainder of 2018.

TAKE A DEEP DIVE INTO YOUR DEPOSIT BASE

Where is the rate-sensitive money in your existing base? If the answer is "the same place it was the last time we saw significant movement in rates," then it might as well be "we have no idea" because the market has changed so dramatically since the last meaningful rate increases. In other words, it's probably time to take another look.

"If you look at the growth in the industry as we've come through this long, protracted, gradual recovery, the growth in balances at those institutions that are still around has been well above average," says Matt Pieniazek. "The irony is that these institutions don't have any experience for how the vast majority of the money sitting on their balance sheets today has behaved or will behave in a sustained rising-rate scenario – they don't have the history. The whole world has changed and there's a lot of uncertainty, without even getting into the impact of technology and the pent-up demand for higher rates and the ability of customers to get instantaneous information about almost anything. So now is the time to take a deeper dive into that deposit base and try to figure out where that potentially rate-sensitive money is hiding."

"There's a fear among regulators that deposits are going to go away and institutions are going to be in a situation they're not prepared for," adds Christine Mills. "This is why it's so important for institutions to really understand their depositors. If your deposits have grown 20% since your last deposit study, you probably don't have as clear an understanding of your deposit base as you think you do – the information is not as granular as it needs to be."

FORMULATE A VERY SPECIFIC OPERATIONAL PLAN

Understanding your deposit base is only step one in a two-step process – that information is only as good as what you plan to do with it. Now it's time to take that information and develop very specific strategies for larger-balance depositors and more mass market-oriented customers, always keeping in mind the marginal costs associated with those pricing strategies.

"From an operational perspective, you have to get your arms around what you already have and have a very specific, delineated game plan for how you're going to handle your larger and mass market customers," explains Pieniazek. "Make sure your board is behind that philosophy, then get that story out to everybody in the organization, because the objections aren't going to come from your ALCO – they're going to come from your lenders and your call center and your branch employees."

WHEN IT COMES TO CONTINGENCY PLANNING, MIND THE DETAILS

From deposit pricing and promotions/marketing plans to funding sources and documentation, a contingency liquidity plan should encompass enough detail to provide the clearest possible idea of how things will play out should a crisis arise. This isn't just good practice for the regulators, of course – it's a great way to keep your team informed, up to date and on the same page.

"In many cases, the contingency plans we see just don't have enough meat to them – the actionable items, who's in charge, etc.," Mills says. "Liquidity is extremely dynamic and fluid, so you have to have a system for determining the severity of a potential liquidity event, how you're going to determine that it's coming and how you're going to react to it. The biggest migration since before the financial crisis is that you used to have liquidity policies that were really short. Now you see policies that are forty pages long because you really have to spell out everything you're going to do in explicit detail. That's a big challenge in this environment."

"A good contingency liquidity plan creates a moving picture," adds Pieniazek. "It shows how a liquidity crisis could materialize or unfold – to what degree that could happen, how quickly that could happen, what about the institution's business model and customer base could cause that to happen. So you see the preemptive measures that would need to be executed to deal with that. Most plans tend to underestimate what could happen, and overestimate how many friends the institution will have when the unexpected occurs."

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