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WHO WILL WIN THE BATTLE FOR DEPOSITS?

Banks haven't seen a deposit environment like this in decades, and it's caught some by surprise.

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Would you operate a branch in a town with 300 people in it? Equity Bank does. "We're just not in sexy places," says Brad Elliott, the founder, chairman and CEO of $4.8 billion Equity Bancshares in Wichita, Kansas.

Investors and analysts during the height of the pandemic were focused on digital and had questions about Elliott's puzzling strategy.

"We were getting criticized for having this branch network," Elliott says. "Today, we're getting rewarded for it."

Equity Bank's loans have been repricing at a higher rate than its deposits, and its net interest margin grew in the third quarter of 2023 to 3.51%, helped in part by the fact that 60% to 70% of the bank's loans are variable rate. Still, Equity Bank is repricing deposits to try to keep them. Plus, loan payoffs have been higher than expected. "I think this is the trickiest cycle that I have managed through," Elliott says. "I think we fell asleep as an industry saying, 'We've got all these deposits. We don't need them.' A lot of people closed branches. The reality is: The bank is valued on its deposit franchise."

As of December 2023, the Federal Reserve raised the federal funds rate 11 times since March of 2022 — its highest level in 22 years. Although rates have been higher historically, it's been decades since banks had to grapple with rates rising this fast, combined with the Fed contracting the money supply as part of what's known as quantitative tightening. Banks got trillions of dollars of deposits during the early days of the Covid-19 pandemic as the government stuffed money into the economy, and those deposits began rolling off bank balance sheets at an alarming rate. Rising interest rates and deposit competition have upended an industry accustomed to low rates and forced banks to pull out old strategies to survive the new street combat. A few banks are remarkably better armed than their peers, namely community banks in small towns and rural areas and those with extensive branch networks.

"You probably had the most rapid acceleration of deposit costs than I have seen in my career," says Jeff Reynolds, managing director at Darling Consulting Group. "This has been unbelievable."

Rising interest rates should benefit banks, eventually, since they can charge more for loans. But depositors are demanding higher rates as loan growth slows. **Banks have a potentially dangerous mismatch if assets, mainly loans and securities, don't reprice faster than liabilities, or deposits, putting pressure on earnings and liquidity.** For most of the industry, that downward pressure on earnings has already occurred.

Community banks saw net interest margins — the difference between interest income and interest expense as a percentage of earning assets — rise slightly from the second quarter to 3.35% in the third quarter of 2023, according to the Federal Deposit Insurance Corp. But margins fell year over year and that had an inevitable impact on earnings, as community banks generate most of their income from loans to their communities. Pretax return on assets declined in the third quarter to 1.21% from 1.51% in the same period a year ago.

"The whole world of funding turned upside down," says Donald Musso, the founder and CEO of FinPro, a consulting firm. "Most banks have seen deposits running out the door."

To keep deposits, banks are repricing them. The cost of deposits has more than tripled since the start of the pandemic. Deposit costs averaged 0.65% in the first quarter of 2020, rising to 2.10% for all insured institutions in the third quarter of 2023, according to the FDIC. Community banks enjoyed stickier deposits and have been less likely to chase rates. They fared a bit better in the third quarter, with deposit costs rising to 1.77%.

One of those community banks is $2.4 billion First Farmers Financial Corp. in Converse, Indiana, a town with just over 1,000 people in it. The bank subsidiary, First Farmers Bank & Trust, is led by CEO Mark "Doc" Holt. In addition to running the bank, "Doc" also owns a veterinary practice in town, where he saw his career transform from taking care of livestock to perfumed poodles. He's been on the board for many years, but only CEO of the bank since 2019, a sort of whiplash experience.

First Farmers went from having burgeoning deposit balances to engaging in "hand to hand combat" to keep them, Holt says. His main problem is trying to fund the bank's robust loan growth. While close to half its loans in agriculture or agribusiness, the bank has benefitted from rising commodity prices during the pandemic for everything from corn to cattle, leading the bank to fund nearly $300 million of new loans last year, a growth rate of about 12% to 15%.

"It's hard to go into towns with 3,000 people and grow $3 million in deposits there," Holt says. The bank has turned to brokered deposits and Federal Home Loan Bank advances for about 19% of its funding: the amount varies quarter to quarter based on demand for loans and lines of credit. The bank also is spending money on marketing and combing through its deposit data so it can call customers who have left the bank or moved large sums of money. Like a lot of banks, it has been shifting some of its deposit mix to higher cost funding such as certificates of deposits, or CDs, leading to a cost of funds of about 1.81%.

"This bank has stayed committed to [lending to] their community," says Reynolds. "The question is how to fund it."

Banks that as of the third quarter answered that question successfully included those with large branch networks such as Regions Financial Corp., Fifth Third Bancorp, M&T Bank Corp. and Wells Fargo & Co., says Gerard Cassidy, head of U.S. bank equity strategy and large cap analyst at RBC Capital Markets. "All of those banks have a very high concentration of consumer deposits, of which a portion of those are noninterest-bearing consumer checking account deposits," he says. "There's still consumers out there that are just happy to sit with lots of money in their noninterest-bearing checking account."

The reason is simple: Most households and small businesses have operating accounts that require thousands or even hundreds of thousands of dollars to cover monthly bills and payroll, depending on the size of the bills. "The high net worth customers have already moved their money out," Cassidy says, "or the banks have had to pay up [to keep them]. But the grandma and grandpa accounts and the consumer accounts, the noninterest-bearing accounts, those are rock solid."

Peter Winter, a senior research analyst who covers regional banks for D.A. Davidson & Co., says Birmingham, Alabama-based Regions, for example, has a lot of branches outside of major cities, and its customers have an average balance below $5,000. **He says banks with a lot of commercial clients or large wealth management divisions, such as BOK Financial Corp. in Tulsa, Oklahoma, and KeyCorp in Cleveland, Ohio, have seen their cost of funds rise more than other banks.**

Also, having few branches may be a bit of a liability. Researchers at Northwestern University and the University of Notre Dame published a report in July 2023 finding that banks with few branches as a percentage of their total deposits saw a larger than average growth in deposits from 2010 to 2022, as they attracted uninsured deposits from corporations and households with a lot of cash. But those deposits took on the appearance of "hot money" when economic conditions worsened. All three large regional banks that failed in the spring of 2023 had small branch densities compared to the size of their deposits.

"The lower the average balance on the account, the less likely it is to move," says Jill Cetina, associate managing director in the financial institutions group at Moody's Investors Service. Her firm analyzed deposit betas, the percentage increase in deposit costs compared to the fed funds rate. Banks with large branch networks often had the lowest deposit betas through the third quarter of 2023 — banks such as Regions, Bank of America Corp. and Wells Fargo & Co.

But that doesn't mean those banks will sail through 2024 unharmed by rising deposit costs.

Wells Fargo Chief Financial Officer Mike Santomassimo said during the third quarter 2023 earnings call that the bank's officers have been pleasantly surprised that deposit costs haven't risen as fast as they thought. But, he said, with quantitative tightening and competition for deposits, "you're going to see deposit costs continue to increase."

Many banks don't have data from a similar, past cycle of tightening, Cetina says. That makes the models banks use to predict deposit costs suspect. "If you onboarded a lot of deposits, particularly during the pandemic period, and you didn't really track that well, you can be surprised," she says. It's been a decade since bankers had to deal with a significant rise in rates or had to understand their marginal cost of funds, an analysis of the impact of repricing different segments of the deposit base, says FinPro's Musso. **"The last thing we want to do is price up our entire deposit base," he says.** "I think now everybody is waking up to the fact that their cost of funds has just risen way too quickly, and they've got to change their thinking on it."

Reynolds advises banks to find where deposits have gone. For the most part, bank customers haven't left their banks. They've just moved money elsewhere. Wells Fargo has been calling customers with CDs in advance of their maturity date to try to keep their money at the bank.

Among other banks focused on existing customers is $8.4 billion Nicolet Bankshares in Green Bay, Wisconsin, which has been plenty of deposit competition in a city with about 106,000 people. "It never ceases to amaze me how bankers [complain] about the loyalty of customers but then offer a deposit special only good for new customers, not someone who has been with you for 20 years," says CEO Mike Daniels.

Like a lot of banks, Nicolet loaded up on brokered deposits and wholesale funding in early 2023 but decreased borrowings by the third quarter in favor of customer time deposits. **"For the first time ever, everyone was focused on one thing: deposits," Daniels says.** Early last November, Nicolet was offering a 5% 12-month CD to anyone who wanted to lock in that rate for that long. The bank also let deposits run off by about $16 million as commercial loan demand softened.

"If you think in the simplest of finance terms, your raw material costs went up 600%, or 500 basis points, in a short period of time, and very few banks were able to reprice the asset side of the balance sheet," he says. "The velocity and movement put everybody back on their heels."

Thomas Broughton III, the chairman and CEO of Birmingham, Alabama-based ServisFirst Bancshares, agrees. "I don't remember ever seeing this amount of deposit competition," he says. And Broughton has been around for a while. He and a cousin founded a bank in 1985. In the 1990s, he served as a regional chief executive officer for Synovus Financial Corp., based in Columbus, Georgia.

Now he heads one of the top performing banks in Bank Director's RankingBanking annual report. But $16 billion ServisFirst was under pressure in 2023 as a commercially focused bank with few branches and a correspondent division sensitive to rising interest rates. Although the bank is growing deposits and eschews wholesale borrowings or brokered deposits, **it saw a 28% decline in noninterest-bearing deposits and declining net interest margins in the third quarter.** "My take on it is that the improvement in loan repricing, it's been swallowed up by deposit repricing to this point in time," Broughton said on the bank's third quarter earnings call. On top of that, customers have been paying off loans. "I was with a customer last week, and he said the best way I can make $16 million is to pay down $200 million of debt," he said.

To cope, Broughton believes bankers have started to focus on taking care of their existing customers and rationalizing deposit costs. "It seems like every two or three days, I get a call," he says. " 'Hey, I've got a friend who's a developer in Atlanta, and he's looking for a new bank.' I say, 'No. Thank you, though.' … We look for customers with a full relationship, and we always have. If people want you to pay up on a money market account, well, do they have their noninterest-bearing accounts with you?"

Some bankers are trying new techniques to attract deposits. Ira Robbins, chairman and CEO of $61.2 billion Valley National Bancorp in New York has focused on diversifying his bank's deposit base to cope with what he calls disintermediation in the banking industry, where consumers and businesses are depositing billions in Starbucks cards and Venmo accounts. Valley National holds about $9 billion of deposits from niche businesses around the country, such as legalized marijuana, technology firms and homeowner associations.

"Historically, a checking account is how we connected with our clients, and that's how they operated their day-to-day life," he says. "Now, there are fintechs that have embedded within that relationship. And I think banks now need to look at what the pools of deposits are and how we go about getting those pools of deposits."

He's concerned about the ease with which customers can move money and how that impacts the banking system. **Platforms such as TreasuryDirect facilitate the quick movement of money in a higher rate environment.** Banks such as Valley National compete with U.S. Treasurys, and the 10-year Treasury note rose above 5% in October. "Banks need to be very thoughtful about how we either partner with some of these intermediaries that are now connected to our clients and how we think about franchise value," Robbins says.

The bank has a large base of midsized business clients, and while rising deposit costs didn't surprise Robbins, the volume of institutional money moving off the bank's books did. "I wish I wouldn't have been that overnight," he says.

Neil Stanley, the CEO and founder of the deposit consulting firm The CorePoint, notes that the industry is grappling with higher rates in an environment where it's much easier to move money than it was a decade ago. **"Years ago, we had high interest rates, but we had no technology," he says.** "Just as we started to get these [he waves a smartphone in the air], interest rates went to nothing … Don't let anyone tell you they have experienced what we are experiencing now in the past, because we have never had this combination before."

He's been advising banks on their deposit strategies, such as using an odd-term CD special — seven or 11 months — to avoid automatically repricing CDs every time they mature. Another tactic he recommends is right-sizing penalties for early withdrawal of CDs for certain customers, matching the financial damage the early withdrawal does to the bank. **Stanley says bankers don't have a playbook for what they're facing today.** "The bankers don't know what to do," he says. "They're not showing [customers] how to manage their money and keep it with them when they graduate from one level to the next."

Deposits are now the focus, and some banks are scrambling to come up with a strategy. "I mean, for the last 15 years, the quality of [a] deposit franchise hasn't really been that visible or that important of a thing," Cetina says. She thinks the pressure on deposit costs is going to stick around for a while. As of late 2023, the Fed planned to continue to reduce the supply of money in the system and shrink its balance sheet. The emergency Bank Term Funding Program is due to expire this spring. The Fed may cut rates in 2024, **but that is dependent on "economic and financial developments" and whether inflation meets the Fed's target of 2% over time.**

If rates drop only about 100 basis points in 2024, Reynolds of Darling Consulting doesn't expect much relief in deposit costs for banks, although higher margins on loans could help make up the difference.

Customers are getting accustomed to higher rates, and it will be harder for banks to lower deposit rates in the U.S. than in Europe, according to Deloitte's 2024 Banking and Capital Markets Outlook. "The U.S. started raising rates faster," says Val Srinivas, Deloitte's senior research leader for banking and capital markets. "The conventional wisdom is higher rates for longer."

If history is any guide, more deposits could move into interest-bearing accounts and timed vehicles such as certificates of deposit. **As of the third quarter, 15% of bank deposits were in timed deposits, according to the Federal Deposit Insurance Corp.** Back in 2006 through 2008, the rate was north of 30%.

Coupled with the International Monetary Fund's forecast that advanced economies such as the U.S. will experience gross domestic product growth of less than 2%, "banks' ability to generate income and manage costs will be tested in new ways," Deloitte's report said. S&P Global Market Intelligence also projected declining earnings in 2023 and 2024 based on the deposit environment and defensive moves to reserve for potential loan losses.

Cetina says banks shouldn't expect deposit costs to improve just yet. "I think you'll know that it's getting better when one of two things happens: when we get back to target on inflation or if we enter a recession."

And if the latter happens, of course, bankers would have a different set of problems.

This article has been updated to correct Neil Stanley's advice on CD early withdrawals.

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