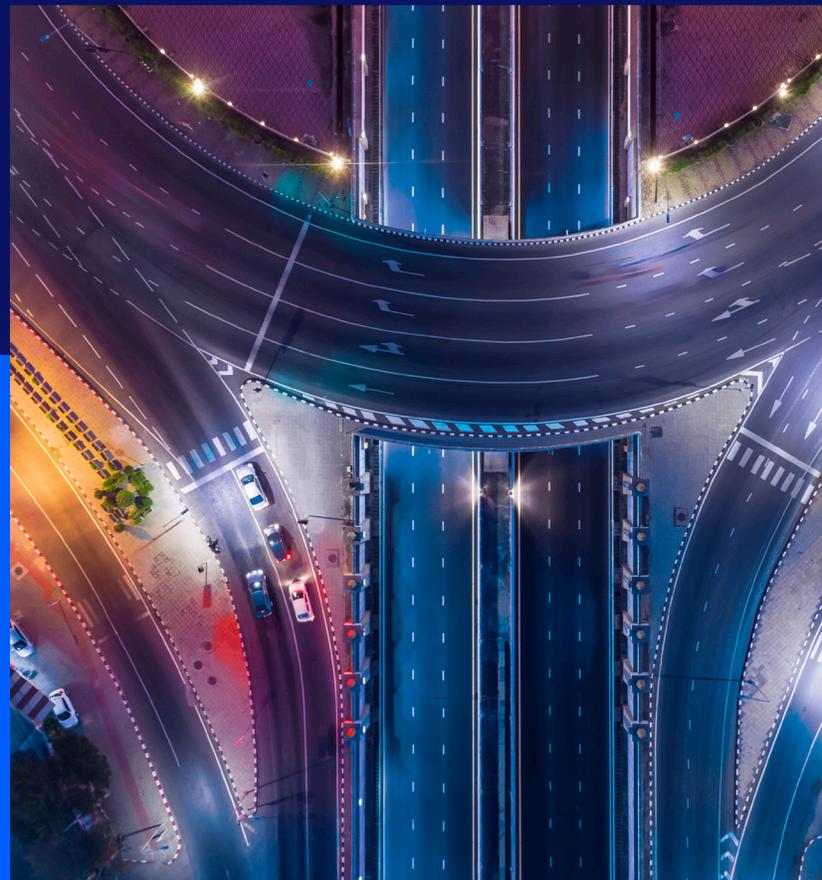


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# **Charting a Course through the Aftermath of Bank Failures: A Strategic Roadmap**



# Introduction

The financial landscape has undergone a profound transformation in the aftermath of several bank failures in the US. This new terrain certainly presents challenges, particular for regional and community depository lenders, however it also presents opportunities for those that are able to proactively and comprehensively approach managing their balance sheets. Reflecting on the impact of these failures offers valuable insights that can inform our future strategies.

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## A shift in strategy

In the initial stages of the liquidity crisis in the US, there was concern that customers might abandon smaller regional and community depository lenders in favor of larger domestic institutions. Contrary to these fears, smaller institutions have demonstrated impressive resilience in defending their deposit bases. In some cases, they have not only managed to retain their customer base but have also expanded them, albeit at a cost. For these community and regional depository lenders, this funding environment has required a strategic shift of focus from one of capital growth, to one of capital conservation, driven by a significant compression in net interest margins.

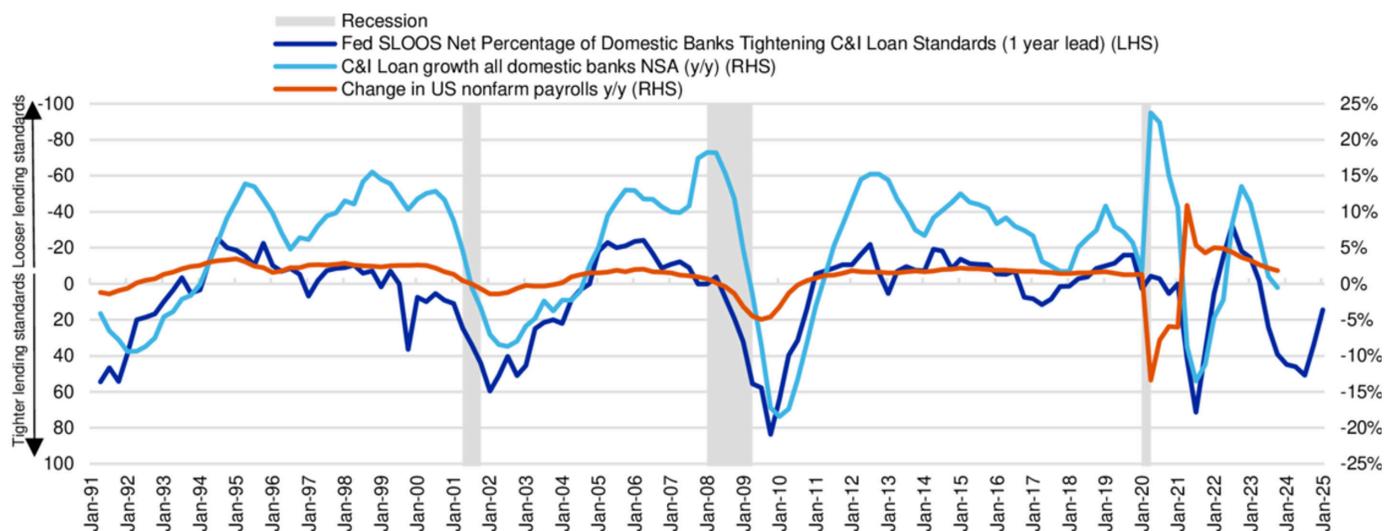
In navigating this shift, banks and credit unions have had to make decisions about their business areas, and rationalize which products and lines of business they commit capital to. Those areas receiving more capital are the ones that either offer lower cost deposit funding base, lower sensitivity to increases in interest rates known as betas, or higher levels of self-funding. In cases where these qualities are not present, more severe actions have been taken. These actions span from the sale of specific individual credits, to whole portfolios of

loans, or even to entire operating lines of the business that did not self-fund. Despite these challenges, a tenuous stability has been achieved for the moment, but vigilance remains necessary in the face of potential future destabilizers, such as the actions of the Federal Reserve, continued increases in credit losses driven by the commercial real estate market, and strained corporate earnings in a sustained period of “normalized” interest rates.

Building off that last example of strained corporate earnings, Exhibit 1 is from the Moody’s Ratings Q4 2023 sector comment, and illustrates how management teams are constraining growth in Commercial & Industrial (C&I) lending. Specifically this shows:

How the recent tightening in banks’ C&I lending standards points toward a deceleration in US banks’ intermediation to corporates in 2024 that could be at least as deep as that which preceded the 2000-01 recession. Furthermore, history suggests that recessions associated with banking strains are both deeper and more protracted.

**Exhibit 1: Bank underwriting standards tighten further but are leveling off for more lenders**



Source: Federal Reserve, BLS, Moody’s Investors Service

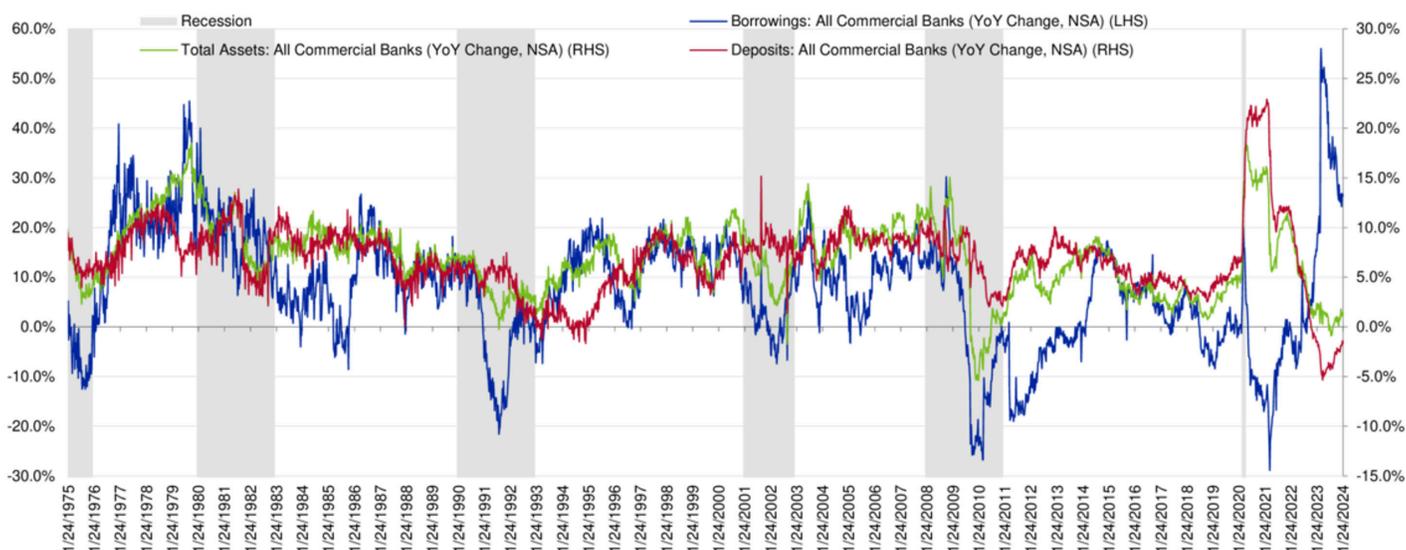
## Regulatory re-focus on liquidity

While market forces are driving much of this shift in strategy, it is important to note that regulators have stepped up scrutiny on liquidity focused matters as well. While this may be expected for some of the larger complex financial institutions, pressure is also being applied at the regional, and community financial institution space as well. The current climate has redirected attention towards the domain of the Asset Liability Committee, with a particular focus on liquidity concerns and credit concerns; citing recent increases in delinquencies for consumer and commercial credit.

As part of this discussion, the core component of bank liquidity that is getting the most focus is deposits,

where banks are being forced to backfill the outflow in core deposits with higher cost time deposits or brokered deposits. In the Moody's Ratings sector comment from early February 2024 titled Weekly deposit decline accelerates as bank balance sheets shrink, Aggregate total deposits across the entire US banking system, including large time deposits, were down 1.7% for the week ending 24 January from a year ago, compared with a peak year-over-year decline of 5.3% for the week ending 12 April 2023 (Exhibit 2). The more recent smaller decline in total deposits from a year ago reflects the ongoing shift to replace some core deposit outflows with large time deposits.

**Exhibit 2: Weekly deposit decline accelerates as bank balance sheets shrink**



Above includes all domestically chartered commercial banks, US branches and agencies of foreign banks, and Edge Act and agreement corporations.

Source: Haver, Federal Reserve H.8 Data

As pressures on deposits continue to mount, to get a sense of how your institution may perform under this sustained “higher for longer” environment, prioritizing liquidity stress testing under a variety of stressed scenarios is crucial. This exercise can offer invaluable insights to management teams and regulators alike, overall, the focus should be enabling an understanding of depositor concentration and depositor behavior.

# Deposit betas, contingency funding plans, and balance sheet management

One of the common ways banks analyze and discuss deposit behavior is the concept of deposit betas. This term refers to the sensitivity of deposit rates to changes in market interest rates. When interest rates rise, banks typically increase the rates they offer on deposits, though usually not by as much as the increase in market rates. This sensitivity is measured by the deposit beta. For example, if market rates increase by 1% and a bank increases its deposit rates by 0.5%, the deposit beta would be 0.5. The impact of deposit betas on a bank's balance sheet management strategies is significant. Banks need to actively manage their balance sheets to mitigate the impact of changes in deposit betas. This management involves a combination of managing their deposit mix, reducing nonstrategic loans and borrowings, and conserving and building their capital and liquidity positions.

Focusing on deposit betas, improving our understanding of what can cause changes in this behavior often involves historical data or industry benchmarks, but this alone may not reflect the actual behavior of depositors in different scenarios. Because of this, it is important to provide management with a mosaic of evidence around the potential impact that various conditions would have on deposit betas, and therefore the bank's financial statements. These conditions could include different levels of FED action, economic activity, customer preferences, competitive pressures, and other variables that may affect deposit flows and pricing.

This mosaic of evidence can be thought of as a collection of relevant data points, insights, and analyses that can help management make informed decisions. It can include both quantitative and qualitative information, such as:

- Scenario analysis: This involves projecting the balance sheet and income statement under different assumptions of deposit betas and interest rate movements, as well as other factors that may influence the outcomes, such as loan growth, credit quality, fee income, and non-interest expenses. Scenario analysis can help management assess the sensitivity and resilience of the bank's performance to various shocks and stressors, and identify potential risks and opportunities.
- Peer comparison: This involves benchmarking the bank's deposit mix, pricing, growth, and beta assumptions against those of its peers, both within and outside its market area. Peer comparison can help management understand the competitive landscape and the positioning of the bank relative to its rivals, as well as identify best practices and areas for improvement.
- Customer segmentation: This involves analyzing the bank's deposit base by different customer segments, such as product type, balance range, tenure, channel usage, relationship depth, and demographics. Customer segmentation can help management understand the preferences, behavior, and loyalty of different depositor groups, and tailor the bank's products, services, and pricing strategies accordingly.
- Customer feedback: This involves gathering and synthesizing the opinions, expectations, and satisfaction of the bank's customers, through surveys, interviews, focus groups, social media, or other channels. Customer feedback can help management gauge the perception and reputation of the bank in the eyes of its customers, and identify their needs, pain points, and suggestions for improvement.

By providing management with a mosaic of evidence around the potential impact of deposit betas, the bank can enhance its decision-making process and optimize its balance sheet strategy, helping the bank achieve its financial goals, mitigate risks, and create value for its shareholders, customers, and employees. In addition to these strategic actions, this analysis also greatly bolsters the creation and testing of a bank's contingency funding plan. Incorporating these behavioral categories into your contingency funding plans, along with the speed of deposit outflows and the operational processes around the deposit and funding mechanisms at the bank will help leaders gain a comprehensive, accurate, and relevant view of the return profile of our operating segments and product lines, empowering them to make more informed decisions about capital allocation.

## Concluding thoughts and earnings

The second half of 2023 saw regional banks across the United States adopt a variety of the strategies mentioned above. Using our generative AI capabilities, we reviewed and analyzed the earnings call materials and transcripts of over a dozen real regional banks. This analysis resulted in several real examples of actions that management teams are taking to manage their balance sheets. These examples provide a clear picture of the evolving landscape of the banking industry and the strategic approaches banks are taking to navigate it.

One key trend that has emerged is a focus on Concentration Risk Management. Banks are proactively avoiding over-reliance on any single customer, or customer segment, both in terms of loans and deposits. To achieve this, they are utilizing various tools to maintain customer relationships while shifting their dependence off balance sheet, thus reducing the potential risks associated with lending concentrations. In parallel, banks are also pursuing Balance Sheet Optimization. They are exploring all possibilities, including asset sales, and even examples of segment sales to private credit firms. Off-balance sheet strategies are also being used for high-cost customer deposits, which gives management teams flexibility to bring some of that funding onto the balance sheet, should they need to bolster their Loan-to-Deposit Ratios. This is being evaluated alongside the percent of deposit base that is non-interest bearing.

Another significant trend seen in the earnings calls is Balance Sheet Restructuring. High-yield but low self-funding assets are being sold off and high-cost wholesale funding is being paid down with the associated proceeds from the sales, which not only improves net interest margin but also strengthens the overall balance sheet. This restructuring is part of a broader strategy to manage liquidity, with banks ensuring strong liquidity positions and reserving capital for businesses where they can establish a full relationship with their customers. Additionally, part of this balance sheet management activity is ensuring flexibility in regards to capital management. Banks are prioritizing the preservation of strong capital levels and are ready to initiate share repurchases if growth slows down or share prices fall, reflecting a proactive approach to managing fluctuations in the market.

Banks are also actively Managing Interest Rate Risk, addressing the inherent mismatch between the interest rates of loans and deposits by seeking to balance asset and liability duration. The duration of their investment portfolio is also being managed to act as a ready source of funds in case there is a need to absorb any unexpected customer-driven balance sheet changes.

In terms of human resources, talent acquisition in the banking teams has been a prominent strategy. Banks are investing in banking talent, with the expectation that these individuals will contribute to growing full customer relationships of their franchises in the future. Some institutions are even hiring individuals exclusively focused on liquidity gathering strategies within their customer facing lines of business. This dedicated focus on managing the deposit portfolio with staff augmentation is another way banks are executing on the strategy mentioned earlier of replacing higher-cost wholesale funding sources with lower-cost deposits acquired through business development efforts, and creating an off-balance sheet funding lever to pull deposits onto the balance sheet based on current funding outlooks.

In conclusion, the banking sector, particularly regional and community banks, is navigating a period of significant transformation due to changes in the liquidity environment. Swift increases in deposit betas and the aftermath of several regional bank failures have management teams renewing their focus on growing core deposits and managing their deposit mix to mitigate the impact of these pressures. Many of them are also taking proactive measures to anticipate changes and adapt swiftly. Key strategies here include liquidity stress testing, understanding depositor behavior, and prioritizing total relationship and enterprise profitability. To execute here, banks are relying largely on traditional approaches such as historical data and industry benchmarks, due to the limitations of their technology. To truly understand changes in depositor behavior and assemble that mosaic of evidence discussed earlier, enhancements in the analysis performed, and the tools that analysis is performed with are often needed. Ultimately, consideration of other critical variables such as FED action, economic activity, customer preferences, velocity of money movement, operational processes, and

competitive pressures is required for the complex and interconnected risk landscape we operate in today.

The effect this is having on bank financial statements is reducing the level of nonstrategic loans and borrowings, shifting the mix of deposit types, and building their capital and liquidity positions. While the challenges faced by the banking sector are significant, they are not insurmountable. With the right strategic approach, this period of transformation brings with it the prospect of growth and innovation. By focusing on liquidity stress testing, understanding depositor behavior, and prioritizing total relationship and enterprise profitability, we as an industry can successfully navigate this evolving landscape.

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