Two "Silent" Killers of Banks: Deposits and Digital
by Charles Wendel

What if the next big banking crisis has little to do with bad loans? Certainly, over the decades bad loans have been the major factor in banks blowing themselves up. Most recently, the dynamite was residential and commercial mortgage lending. And yes, many banks continue to pursue volatile areas like auto loans and take participations in shared national credits others manage and, in the event of an economic downturn, risk being "stuffees". Recently, I have even had two bankers and a business reporter question the activities of one fast growing regional bank that has pursued a national approach to construction lending. Guess who?

While the next banking crisis might result from lending, there are two other areas that could turn out to the "silent killers" of banks, any of which are unprepared for the changes they require. Consider what is happening regarding deposits and digital.

Deposits: more expensive and elusive. As rates rise and loan/deposit ratios edge up, bank management needs to address a deposit environment that may be more volatile that they have ever experienced. Recent articles and research point to some disturbing issues for banks regarding deposits:

- Banks will have an increased dependence on interest-bearing deposits in a rising rate environment
- Business deposits will also cost more
- The fight for funding will increase. An article in Banking Exchange by Jeff Reynolds states that for banks from $1-15B, "15% had loan-to-deposit ratios greater than 95% back at the end of 2012. Today, 33% are over that mark. For that entire pool of banks, the average loan-to-deposit ratio has increased from 78% to 87%. As a result, more banks are struggling to find funding at the margin to continue to feed the loan machine."
- We all know of lenders who failed because of concentration risk. Many banks, in particular those smaller and mid-sized, face the same risk related to deposits. This should be a red light for many banks. From the same Jeff Reynolds article: "It is not uncommon to find that fewer than 5% of the depositors in a given community bank control as much as 40%-50% of total deposits."

Given the predominance of the 80/20 rule elsewhere in life, that should not be a surprise. But, it should be a wakeup call for banks that are relying on quiescent depositors (often in rural areas) to remain in place as a bank levers those funds to lend in areas (cities) in which greater loan needs exist. In effect these loyal depositors are helping to subsidize the bank's funding costs, but maybe no more.

Many banks are making the dangerous assumption that they will be able to hold on to deposits from their low loan growth but deposit rich geographies. But, banks face a tougher competitive environment for deposits with some aggressive competitors like Goldman Sachs entering the arena. As rates rise and more competitors pursue deposits, many customers (probably those with the largest balances) will become more aware of their options. When banks were paying close to zero for deposits, inertia can be expected. As rates rise and more banks advertise their superior rates, relying on inertia is a mistake.

Banks should expect to pay higher rates for deposits, suffer from higher operating expenses to attract and retain deposits, and, potentially, see borrower delinquencies rise as easy money at relatively low rates disappears. Some depositors are already waking up; expect more to do so. Operating with a proactive approach to key depositors seems a better course than hoping the customer will continue to be ignorant of his choices.

The second bank killer may be digital banking. Most banks seem tentative and unsure about what digital banking involves as well as the transformation process required to provide a digital customer experience. Instead, banks stick their toe into digital (a digital application here and a digital platform there) without developing an overall bank wide approach. In part that is because both the concept and the costs are daunting.

Digital shows one area in which a few banks are investing heavily with the expectation of becoming leaders; other banks should beware. In a recent blog Chris skinner quotes a presentation by Lloyd Blankfein of Goldman Sachs: "'Engineering underpins our growth initiatives' says a summary page, and it doesn't mean financial engineering. In fixed income, currencies and commodities, engineers are 25 percent of headcount, and the presentation touts growth in Marquee [software platform] and 'systematic market making.' In equities, Goldman touts its quant relationships. In consumer banking (now a thing!), the centerpiece is Marcus, Goldman's online savings and lending platform. And in investment banking, 'Engineering enhances client engagement through apps, machine learning and big data analytics.'"

Skinner also refers to an article by Jeffrey Bloom that tracks big bank job ads. At Goldman and JP Morgan, engineering job ads are 25% and 8% of the total, respectively, well above other banks. This level of investment indicates that these banks understand the changes required to provide a digital customer experience. Contrast their commitment to a regional bank we know where "digital" is simply one of ten sections of the bank's strategic plan and most of the line bankers have no idea how to pursue this initiative. As with deposits, this bank and others depend on inertia keeping customers doing their business the traditional way.

Most banks lack the appetite, capabilities, and/or dollars to pursue a bank wide digital transformation. While big name consultants want banks to go down this route, it involves much unchartered territory, massive cultural disruption, and the potential for eroding the bank's current performance. Beginning with a single business line or function may make the most sense. And, what more important area to place a digital focus on than deposits?