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Banks Face New Liquidity Challenges

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Executive Summary

Central banks have implemented the **largest and fastest interest rate hikes in recent history**, and elevated rates should persist in the near future

As rates have risen, the financial system moved into **disequilibrium**, so banks must plan for fragility, including **liquidity challenges**

While most global banks currently appear **well-positioned from a regulatory perspective**, Bain's banking health check reveals substantial **variation in liquidity management** performance

The battle for **rate-sensitive balances** is underway. **Deposit mix could rapidly shift**—up to $4 trillion to term deposits in the US. Deposit rates will rise, **further increasing the cost of funding**. Banks face big risks if they misjudge the balance between preserving profitability and retaining deposits

Banks face key challenges in deposits:

- Upward pressure on rates from **new competitors**
- **Lower barriers to switching** driven by the ease of mobile banking
- **A culture of complacency** and **lack of rigor** in measuring and managing liquidity
- **Insufficient data and tools** to aid decision making in high-rate environments

Banks can take **five** actions

01 Perform a **liquidity health check**

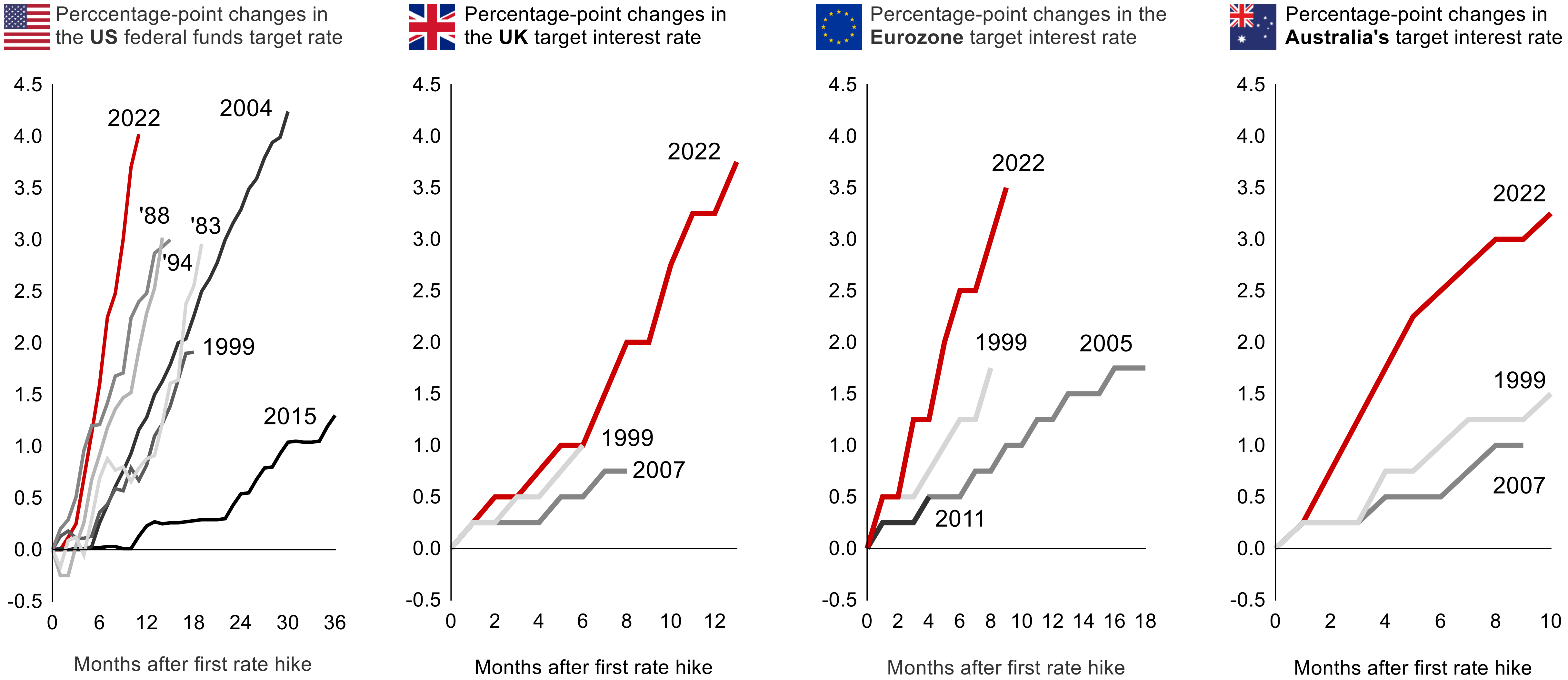
02 Redefine their **funding strategy** to reduce liquidity risk exposure

03 Improve **liquidity steering**

04 Integrate advanced data and analytics into **customer deposit strategy**

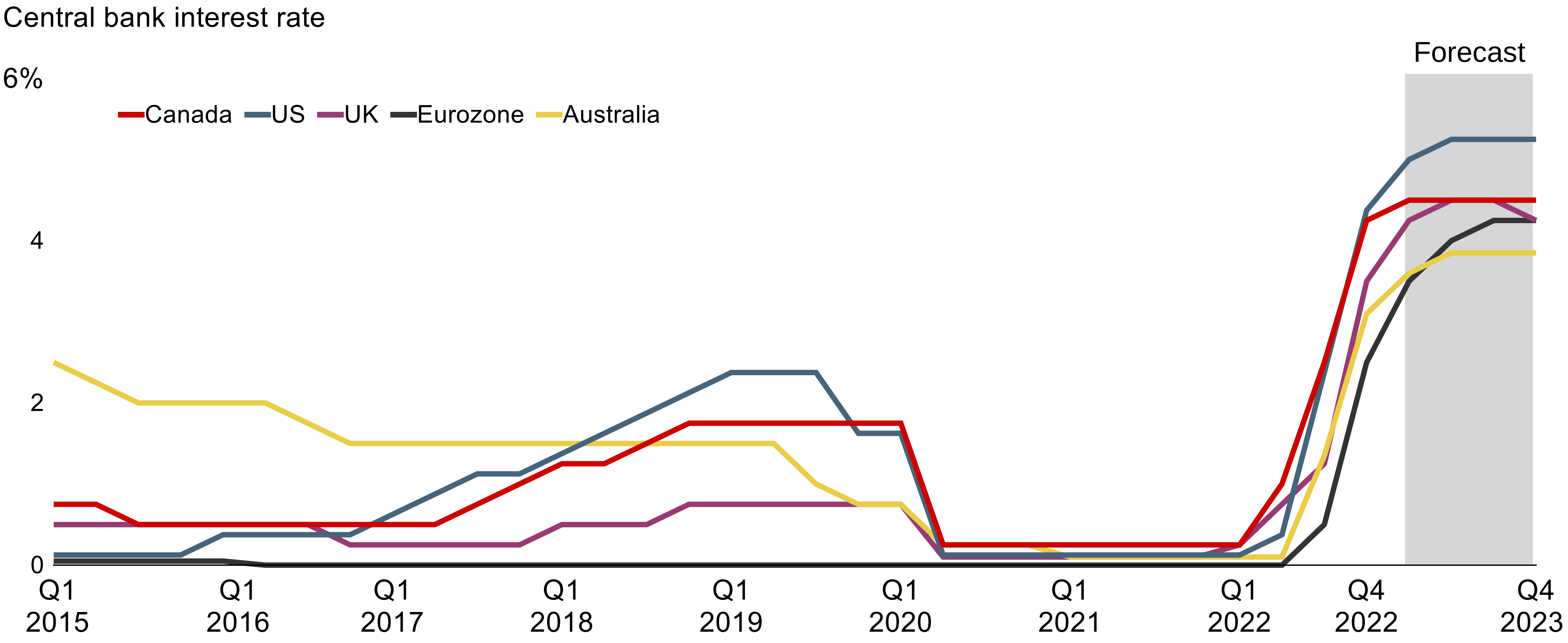
05 Improve **liquidity accuracy**

Central banks have been implementing the largest and fastest interest rate hikes in recent history



Sources: S&P Capital IQ; BIS

Elevated rates are expected to persist as central banks work to curb inflation



Sources: BIS Central Bank Policy Rates (historical); TradingEconomics.com (forecasts)

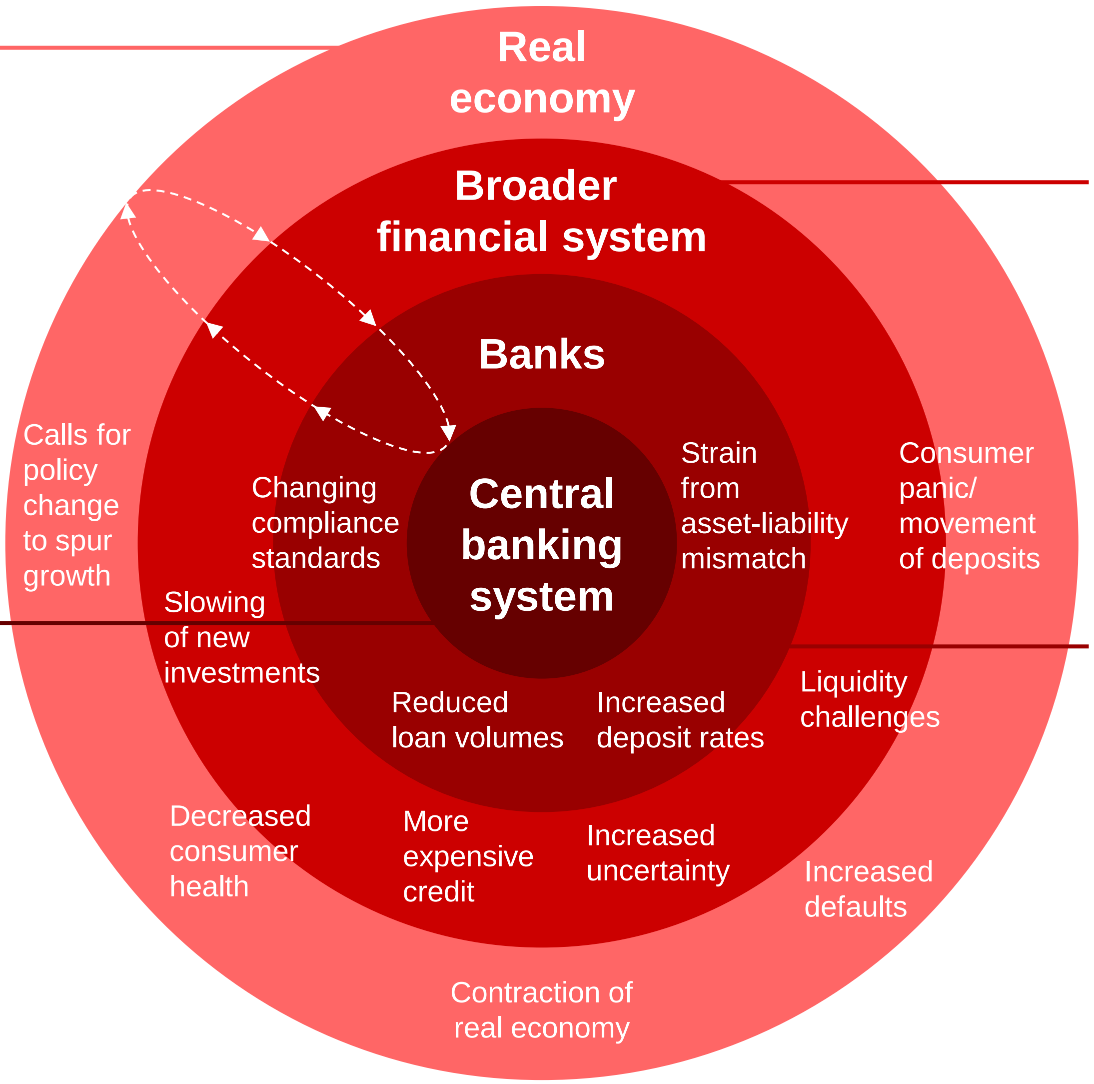
With rising rates, the interconnected financial system has moved into disequilibrium, so banks must plan for new areas of fragility

Real economy

Experiences significant value destruction, sparking debates about policy and regulation to promote growth

Central banking system

Creates conditions for disruption through sustained expansionary policy followed by rapid tightening



Broader financial system

Slows as credit gets more expensive and availability declines; suffers from collapses in specific sectors

Banks

Suffer from liquidity and capital issues stemming from asset-liability mismatch, resulting in higher deposit rates to attract consumers and shrinking loan volumes

Source: Bain & Company

Recent experience suggests regulators, ratings agencies, investors, and consumers will scrutinize liquidity more intensely

“ Deposit flight from small lenders spurs $98bn weekly outflow from US banking system.

FT FINANCIAL TIMES
MARCH 25, 2023

“ EU Regulators to Rethink Liquidity After Credit Suisse Unravels.

Bloomberg
MARCH 23, 2023

“ When Moody's downgraded the credit-rating outlook of the U.S. banking system earlier this month, it too cited the threat to many lenders' deposits: ‘Banks with substantial unrealized securities losses and with non-retail and uninsured U.S. depositors may… be more sensitive to depositor competition or ultimate flight, with adverse effects on funding, liquidity, earnings and capital.’

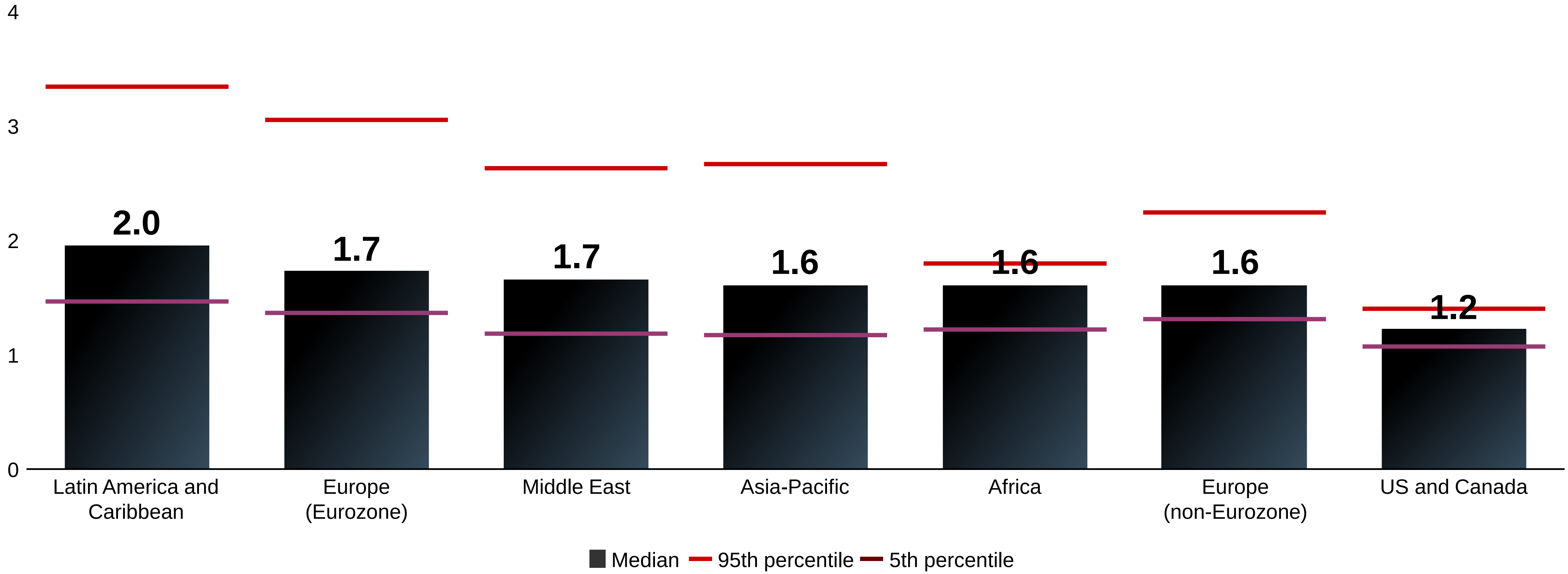
THE WALL STREET JOURNAL.
MARCH 29, 2023

“ The White House said federal regulators, in consultation with the Treasury department, should consider rolling back Trump-era rules that loosened liquidity and capital requirement for banks with between $100bn and $250bn in assets.

FT FINANCIAL TIMES
MARCH 30, 2023

From a regulatory perspective, large banks are well-positioned in their liquidity coverage ratio

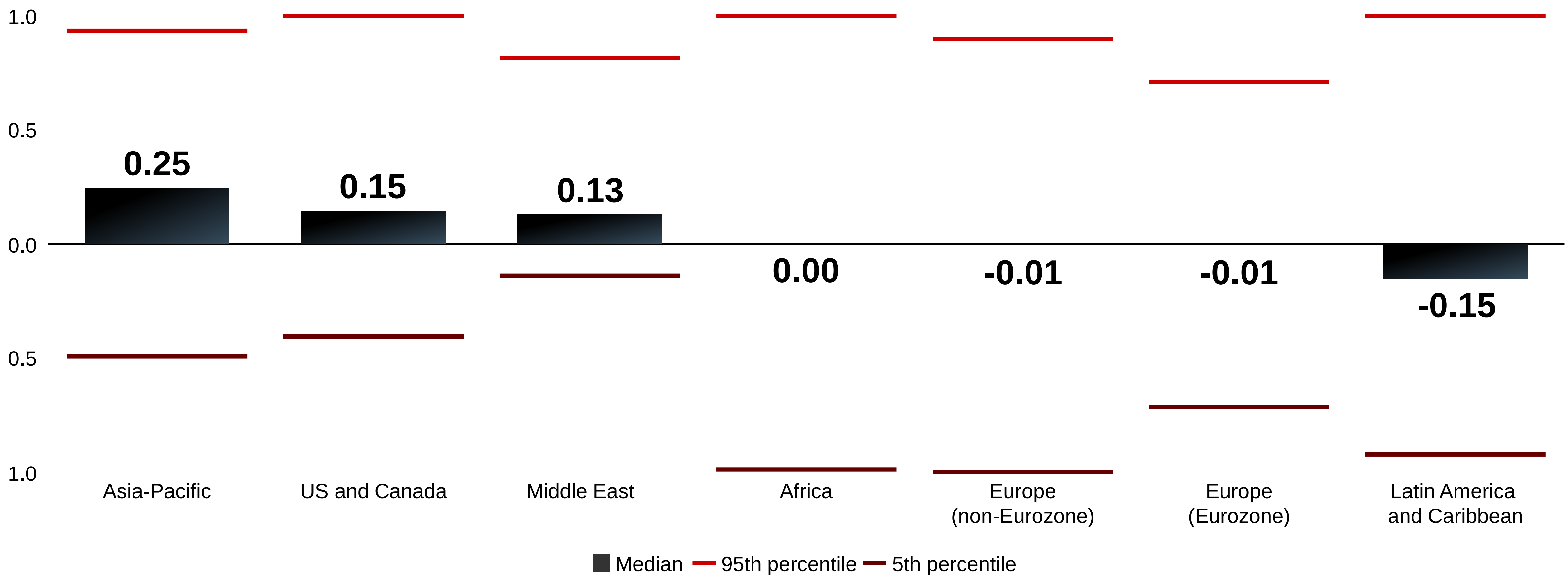
Liquidity coverage ratio, 2022



Note: Data covers only banks that reported LCR for 2022
Source: S&P Capital IQ

From a managerial perspective, banks' positions are far more varied

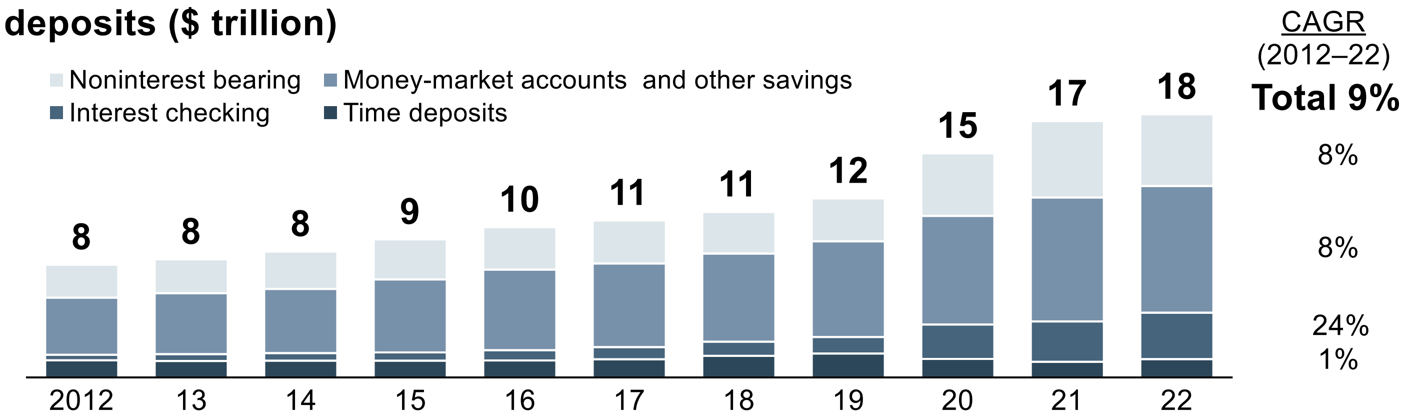
Bank health check liquidity score, 2022



Note: Liquidity scores for each region were calculated for all banks covered by the Bain Bank Health Check Model in the region; the liquidity score for each bank was calculated based on two metrics— loan-to-deposit ratio and (total debt minus liquid assets) / total assets.
Source: Bain Bank Health Check

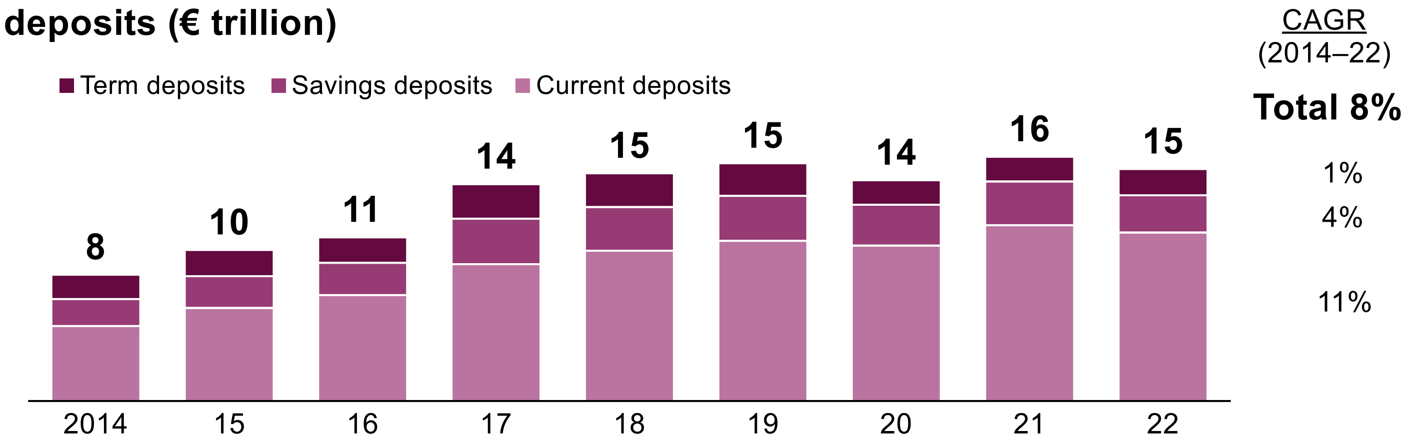
As savings vehicles provided few advantages, checking/current deposits grew and **they may be shifting as consumers look for higher rates**

US bank deposits ($ trillion)



Interest checking share of total	7%	8	9	8	10	11	11	12	21	22	24

EU bank deposits (€ trillion)



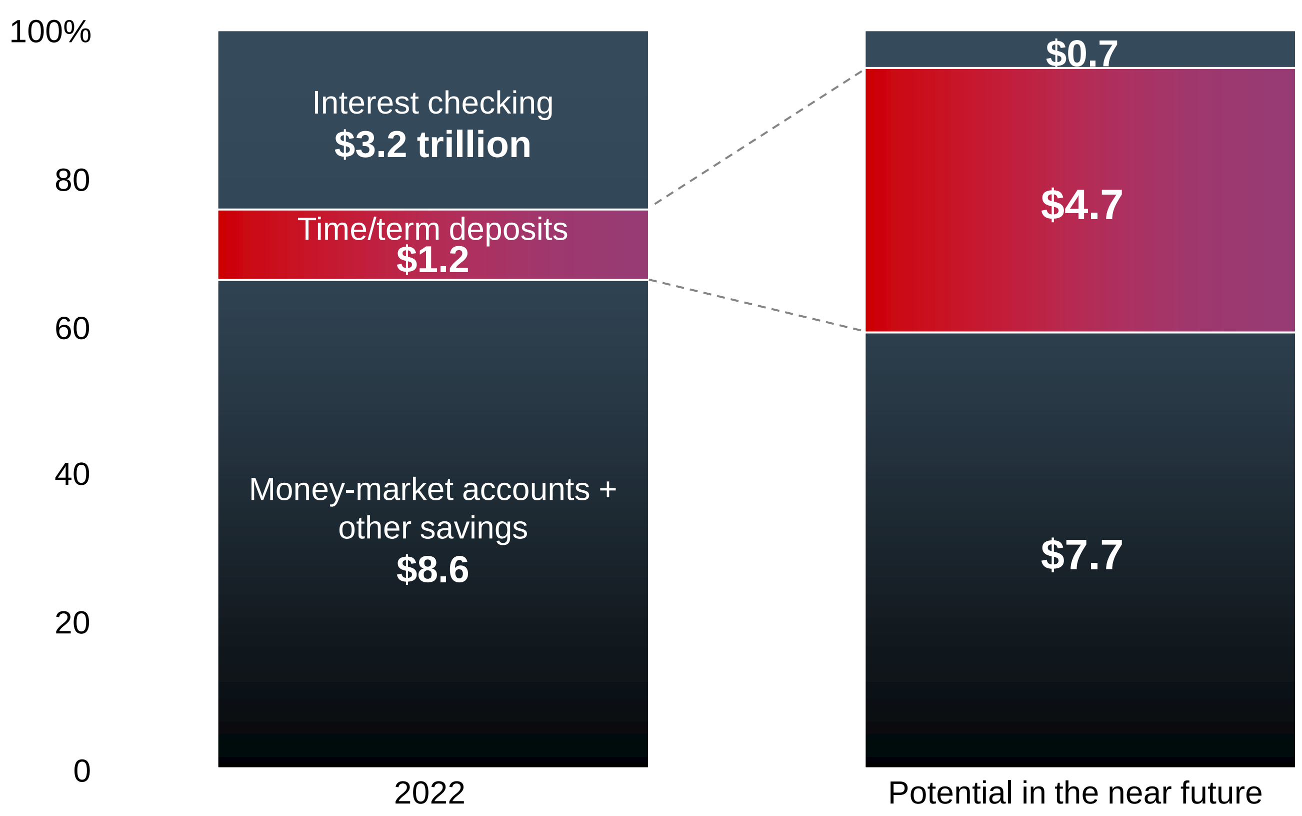
Current deposit share of total	58%	60	63	61	65	67	70	71	72

Note: US bank deposits include interest-bearing and noninterest-bearing deposits for US offices, and excludes credit unions; EU deposit totals were sourced from ECB, and the amounts of current, term, savings, and other deposits were sourced from Fitch; the total for 2022 was calculated as total deposits for 2021 times year-over-year growth as sourced from monthly ECB data
Source: S&P Capital IQ: FDIC; ECB; Fitch

The economics of deposits will deteriorate with increased rate competition and volatility

$3 trillion to $4 trillion could shift to higher-cost time/term products

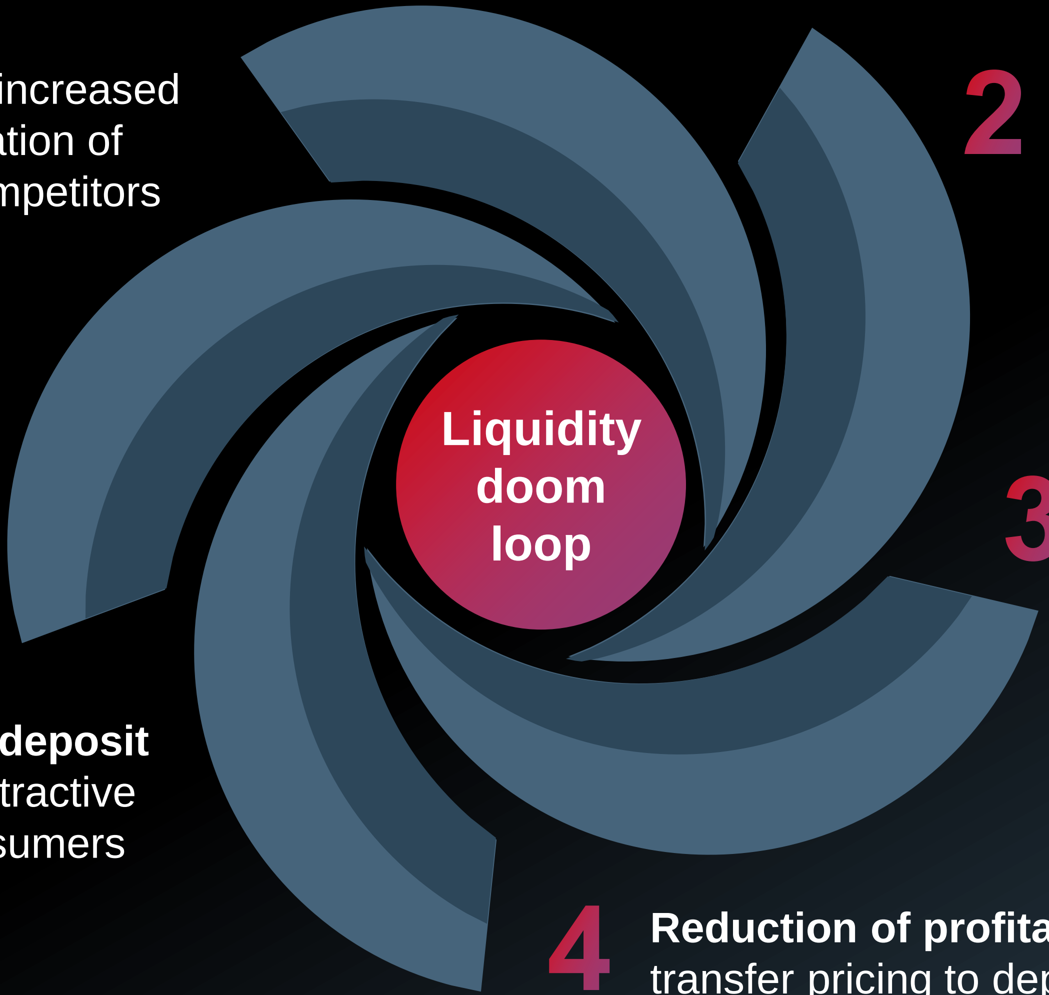
Share of US interest-bearing deposits



Price competition	Increased volatility/ reduced stickiness
✓	✓
✓	
✓	✓

Note: Future projections based on 2004–06 deposit composition, the most recent period of high interest rates
Source: FDIC; Bain & Company

Banks must avoid a liquidity doom loop as they try to balance profitability with retaining deposits



1 **Deposit escape** due to increased competition and proliferation of attractive offers from competitors

2 **Stressed regulatory liquidity ratios** due to deposit escape and absence of rigorous measurement

3 **Requirement to access more expensive forms of liquidity** to stabilize both regulatory and managerial ratios

4 **Reduction of profitability**, lower fund transfer pricing to deposits business

5 **Pressure to preserve deposit profitability** via less-attractive offers and rates to consumers

Source: Bain & Company

Traditional banks will face key challenges in the battle for deposits

Competition	Tech-savvy customers	Mobile money movement	Complacent culture	Paucity of data
Competition from neobanks via aggressive pricing, which raises costs and reduces effective maturity of savings	More **tech-savvy** customers with more digital banking relationships	**Mobile money movement** and banking making it easier than ever for customers to transfer deposits among banks The share of US customers using Internet or mobile banking jumped from 52% in 2017 to 66% in 2021, according to the FDIC	**Complacent culture** and **insufficient rigor** in liquidity measurement and management in the new context of high-cost and scarce liquidity	**Paucity of data** on customer behavior in a high-rate environment **impedes data-driven decision making** on pricing and offers

Sources: FDIC, Bain & Company

Banks can take five steps to address this new context and attain liquidity management excellence

01	**Liquidity health check**	Assess current and future liquidity positions (under both stress scenarios and status quo approaches) to estimate the degree of vulnerability of liquidity/asset and liability management positions
02	**Funding strategy**	Revise funding strategy to reduce liquidity risk exposure without suffering substantial losses
03	**Liquidity steering**	Evolve processes, activities, tools, and policies to steer commercial activity toward healthy liquidity outcomes
04	**Customer deposit strategy**	Integrate advanced data and analytics into deposit pricing and product offering strategy
05	**Liquidity accuracy**	Increase rigor of liquidity measurement and calculation via improved data management and processes; more accurately represent liquidity coverage ratio and nonfinancial risk to the regulator and market

Source: Bain & Company

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