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When the tide turns: Optimizing US commercial banking deposits

Corporate-client deposit growth has been strong but won't last forever. Now is the time for commercial banks to update their approach to forecasting and strategic planning.

by Ryan Cope, Chris Gill, Jayden Liu, and Manthan Pakhawala

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US commercial banks saw remarkable growth in deposit balances from their corporate clients in the first 18 months of the COVID-19 pandemic, increasing 34 percent from March 2020 to late 2021 (Exhibit 1).[1] While some of this was normal growth in business activity and an increase due to companies raising balances to make up for higher fees after cuts to earnings credit rates (ECRs), McKinsey estimates that roughly 60 percent of the growth spurt is attributable to "surge factors" related to COVID-19: the combined force of government stimulus and corporations drawing on their credit lines to build precautionary liquidity.

Crucial for banks is the matter of how long the glut of deposits will last. In October 2021, when McKinsey surveyed US commercial banking leaders on the extent and speed of an eventual runoff of excess deposits, 40 percent of respondents said they expected no decline over the coming 12 months.

However, the tide will turn. Whether it turns sooner, or later—and the Fed's stance on raising interest rates in the near term would argue for *sooner*[2]—commercial banks will need to recalibrate their strategies for retaining an optimal level of deposits. As we discuss in this post, client insights and innovative pricing can inform this recalibration.

Lack of consensus on sources and uses of 'excess' deposits

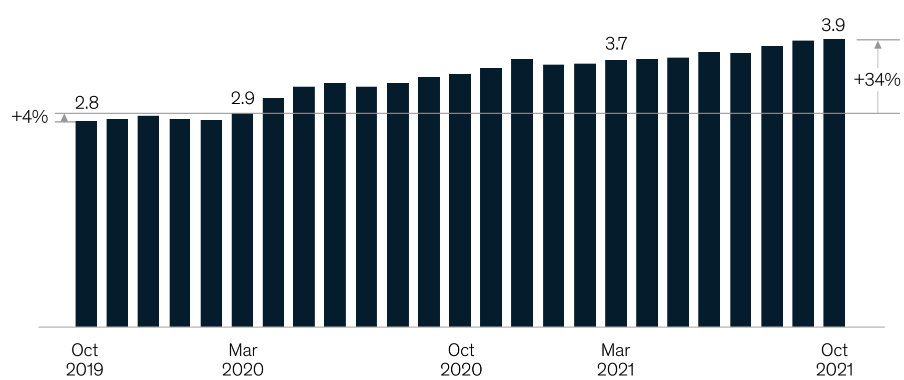
Commercial banking leaders hold differing views of the source and durability of the new higher level

[1] Since then, growth has been steady but not striking.
[2] Jeff Cox, "Federal Reserve approves first interest rate hike in more than three years, sees six more ahead," CNBC, March 16, 2022.

Exhibit 1

Balances surged after March 2020 and continued to climb, with around 60 percent of growth attributable to 'surge.'

Earnings credit rate (ECR) DDA[1] collected balance per relationship
$ million



Causes of the balance increase, %

Estimated surge
Remainder of balance growth after ECR factors and organic growth are accounted for, as a result of many factors, including credit line drawdowns, rate drops, and pandemic relief (eg, government stimulus) that would not have occurred in a normal year

ECR reduction
Amount of balance increase needed to pay the same amount of fees prior to ECR cuts

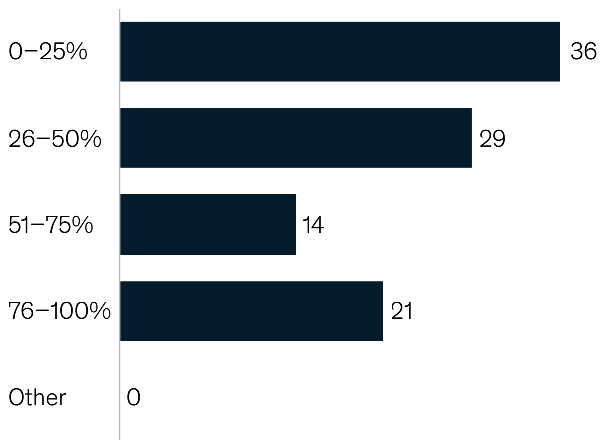
Organic growth
Historical annual balance growth

[1] Demand depost account.
Source: McKinsey GCI Commercial Deposits Quarterly Survey Q3 2021

Exhibit 2

Liquidity lenders are divided about the impact of surge factors on the rise in deposits.

How much of the growth in deposits during Q1 2020–Q2 2021 do you attribute to the surge?[1]
% of respondents, n = 14



[1]We define surge deposits as the recent growth in balances due to rate drops and pandemic relief (eg, government stimulus) that would not have occurred in a normal year.
Source: McKinsey GCI Analytics Portfolio Navigator

of deposits and its reliability as a source of loan funding, according to the McKinsey survey. About one-third of bankers estimated that surge factors—the unusual conditions of interest rate drops and government stimulus—were responsible for growth in deposits of 25 percent or less, while about one-fifth attributed between 75 and 100 percent of the total increase to the surge (Exhibit 2).

When it comes to the reliability of surge deposits as a foundation for commercial lending, bankers' views were in two broad camps. In a survey earlier in 2021, after balances had significantly risen, roughly one-third of respondents indicated their banks placed no restrictions on lending surge deposits, while the rest said their banks closely limited what they would lend, with roughly one-fifth of banks not lending any of the surge increment.

That expectations vary makes sense. No one in the banking or corporate arenas has experienced a worldwide pandemic of COVID-19's scope. Also unprecedented were the amount of capital made available from government programs and the low interest rates that facilitated precautionary drawing on credit lines or raising fresh capital. Under such novel conditions, no one can be certain what level of action is needed to protect their businesses.

Bankers do align, however, on their expectations for short-term growth of deposits. As of October 2021, the great majority were forecasting a change in deposits of just plus or minus 5 percent through the first quarter of 2022. For comparison, the long-term organic rate of growth in deposits prior to the pandemic averaged about 6 percent per year.

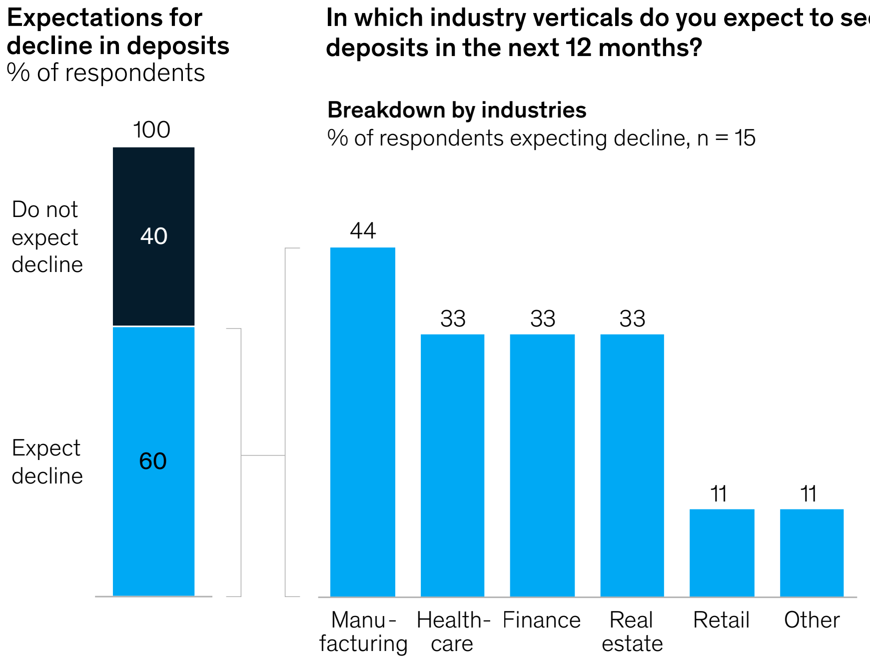
As mentioned earlier, a significant minority of bankers surveyed predicted no decline in surge deposits over the coming 12 months. Those who did see reductions coming were most likely to select manufacturing as a client industry that would see drawdowns (Exhibit 3). After manufacturing, they most often predicted drawdowns from clients in healthcare, finance, and real estate.

'Nobody knows anything'

Writing about the motion picture business, American screenwriter William Goldman, in a 1983

Exhibit 3

Of the six in ten respondents who predict deposits will decline over the next year, a plurality foresee it from manufacturing clients.



Source: McKinsey GCI Commercial Deposits Quarterly Survey Q3 2021

memoir,[3] said, “Nobody knows anything.” He went on to explain that this observation was less a blanket criticism of management and more a recognition of how hard it is to predict the success of individual movies reliably. Audience tastes are quite complicated and subject to constant change, and movie plots are difficult to evaluate rigorously.

An equally complex set of variables faces banks trying to manage surge deposits. The forces causing the surge were unprecedented and only partially understood; low interest rates distorted the supply, demand, and prices of commercial and industrial lending; and the future paths of demand, capital investment, and growth in the real economy are uncertain.

But if nobody really knows anything, a strategy of leaving the surge situation to resolve itself could turn out to be unsatisfactory for both clients and banks. Banks have a better alternative: employing scenario planning to develop a range of actions to take depending on the rate environment.

In recent conversations with banks, we have found wide differences among deposit strategies. Most banks, flush with deposits from the surge, are willing to lose a significant amount of deposits in order to maximize net interest margin, so they may delay raising rates. According to our commercial deposits survey in first quarter 2022, over 50 percent of respondent banks reported a commercial-loan-to-deposit ratio of under 80 percent, which provides

[3] William Goldman, *Adventures in the Screen Trade*, New York, NY: Warner Books, 1983.

some room for deposit exits. However, these deposits may be tied to other business functions, such as cash management or depository services, as well as to legacy employee incentives. This misalignment between liquidity priorities and sales team incentives could result in banks holding on to more deposits than they intend to, though net interest margins would shrink.

In such an environment, banks' existing models for forecasting deposit balance levels—which have tended to gauge only the relationships between interest rates and deposit balances—do not capture the effects of the additional forces currently at work. Historical models are likely to be unreliable, and banks will need to revise their playbooks to reflect the new dynamics.

Finding the right path in the dark

Despite the high degree of uncertainty, commercial banking leaders can optimize their banks' levels of deposits in three ways:

— *Fortify forecasting models.* Banks should develop deposit estimation algorithms that are better informed by new types of data—including quantitative, account-level data on client payment flows—and supported by outreach to understand clients' views of current deposits and plans. Additionally, few banks' forecasting factors incorporate Fed balance sheet activity and quantitative tightening or easing. Given that Fed action was one of the most significant forces behind the surge in balances, banks may be omitting information that might better predict their portfolio changes. Models should also recognize that clients will take a range of actions in adjusting their balances in the future. Moreover, liquidity leaders do not expect historical interest rate betas to hold, a factor that calls for forecasts in wider bands, coupled with the ability to rapidly adjust modeling and strategy (perhaps even daily).

— *Refresh pricing strategies.* Banks need a more holistic understanding of their client relationships to know what balances and products to emphasize. An environment of rising interest rates will encourage some clients to favor money and capital market instruments with higher potential returns—in which case, banks may see billions flow out of excess deposits, which could force the decision of allowing balances to leave without attempts at retention. As noted earlier, banks may be willing to allow the departure of a portion of balances that aren't contributing to funding loans, but the balance shifts could be surprisingly large, so the betas need to be dynamic and reactive to balance movement.

  Increases in rates could create a slippery slope toward lower profitability, but flexible and tailored rising-rate environment ECR and interest rate pricing should help banks retain deposit balances. Furthermore, the typical strategy of banks adjusting interest products immediately and holding on ECR adjustments will need to be reevaluated, with any changes incorporated into models. The result may be a delay in raising rates for both products this time around. However, such a wait-and-see dynamic will challenge traditional modeling.

— *Deepen wallet share.* Banks that hold the line on pricing with rising rates will likely endure attacks from competitors willing to pay premiums on balances, so those banks will need to pick their battles quickly. Being a client's lead lender will still dictate who dominates in banking wallet share, and banks need to determine where they lead and can deepen relationships to retain deposits, versus where they will struggle and thus need to deprioritize. Many banks have pressed hard on deepening share with their core clients, as integration of cash management and other services with deposits should be easier to conduct while fee offsets are high. This approach can secure higher future demand for holding balances in a rising-rate environment. But campaigns to expand wallet share, whether through fee-based services or deposit gathering, can take the better part of a year to show results, so banks should take steps now to secure wallet share, rather than try to catch up later.

Importantly, commercial banks will need to evaluate and implement these measures with clients individually. Companies within industry verticals may indeed take roughly similar steps toward their operating accounts, but banks need to recognize the wide variations among companies—in their depth of resources, relative strengths coming out of the pandemic, working-capital positions, and philosophies toward financial management.

When conditions spur banks into action, those that can recalibrate their time-tested strategies for the new normal and design them around individual client needs will be best positioned to win.

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