Banks shift deposit composition amidst cost-cutting efforts

By PSDLAF

Deposits have continued to build up on bank balance sheets, prompting banks to adopt differing strategies, including setting balance limits for some individual commercial clients in an effort to minimize excess funding amid soft loan demand.

Total deposits across the industry in the U.S. grew 3.9% sequentially in the fourth quarter of 2020, according to data from S&P Global Market Intelligence. The increase was led by a 32.6% jump in transaction balances, typically banks' lowest-cost funding base. Overall during the year, deposits surged 23.2% from the end of 2019, and transaction balances more than doubled.

The bank analytics and advisory company Novantas published a survey of 40 large commercial banks and found that 72% had taken steps to actively discourage commercial deposit growth, with many using "reverse tiering," which involves lower interest rates for higher balances. According to Peter Gilchrist, executive vice president at Novantas, "It's a basic balance sheet management issue. There's nowhere to put [the excess] deposits. Including fees banks assess for deposit insurance, the surfeit of liquidity has led to slightly negative effective interest rates for some large clients." Across the industry in the fourth quarter, funding costs ticked down even further from already near-zero levels with the cost of savings deposits hitting 11 basis points. Broadly, banks are intent on adding new commercial customers, focusing on clients that sign up for multiple services even as they work on "off-loading the excess deposits," Gilchrist said.

Bank balance sheets remained sodden with excess liquidity. As banks struggled to put deposits to work, the industry's loan-to-deposit ratio fell to 59.6% in the fourth quarter from 71.51% a year earlier. As the treasury curve has steepened over the last several months, banks are likely to see a tailwind to profitability in the coming quarters as the economy recovers.

Slower loan growth compared to deposit growth over the past year has placed downward pressure on banks' net interest margins. Net interest margin is a measure of the difference between the interest income generated by banks and the cost of deposits and other liabilities.

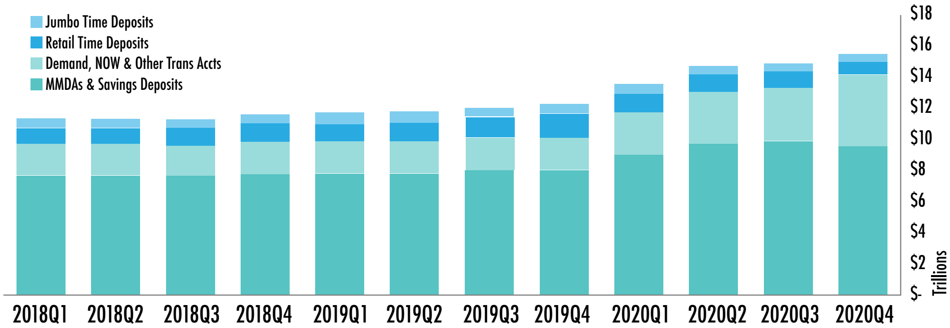
Banking trends: first quarter 2021 highlights

For the 5,001 FDIC-insured commercial banks and savings institutions, full-year 2020 net income totaled $147.9 billion, a decline of $84.9 billion (36.5%) from 2019. FDIC-insured institutions reported fourth quarter 2020 net income of $59.9 billion, up $5 billion (9.1%) from a year ago.

The quarterly increase in net income was primarily attributable to an $11.4 billion (76.5%) decline in provision expenses between the third and fourth quarter of 2020. Slightly more than half (57.4%) of all banks reported year-over-year increases in quarterly net income, and the percentage of unprofitable banks in the fourth quarter remained stable from a year ago at 7.3%. Average net interest margin (NIM) was down 60 basis points from a year ago to 2.68%, as the decline in average earning asset yields outpaced the decline in average funding costs.

Quarterly provisions for credit losses totaled $3.5 billion, down nearly 77% from the third quarter of 2020. The decline in provisions for credit losses was not broad-based, as less than one-third (31.2%) of all banks reported year-over-year declines. Noncurrent balances for total loans and leases increased $1.5 billion (12.8%) year-over-year. The net charge-off rate declined by 13 basis points from a year ago to 0.41%. The annual decrease in net charge-offs was attributable to a $3.4 billion (39.7%) reduction in credit card net charge-offs.

DEPOSIT COMPOSITION



Source: S&P Global Market Intelligence

Total assets rose by $664 billion (3.1%) from the previous quarter. Cash and balances due from depository institutions rose by $357 billion (12.6%). Securities holdings rose by a record-high quarterly dollar increase of $321.4 billion (6.7%). Total equity capital increased by $41.9 billion (1.9%) from the previous quarter. Quarterly net income in the fourth quarter totaled $59.9 billion, exceeding declared dividends of $21.8 billion, contributing $38.1 billion to retained earnings. The number of institutions on the FDIC's "problem list" remains unchanged from the previous quarter at 56. During the quarter, three new charters were added, 31 institutions were absorbed by mergers and two banks failed. *Source: FDIC Quarterly Banking Profile*

The Federal Reserve declined to extend a pandemic-era exemption

The Federal Reserve (Fed) declined to extend a pandemic-era rule that relaxed the amount of capital banks had to maintain against Treasurys and other holdings (March 19, 2021).

In a brief announcement, the Fed said it would allow a change to the supplementary leverage ratio (SLR rule) to expire March 31. The initial move, announced April 1, 2020, allowed banks to exclude Treasurys and deposits with Federal Reserve banks from the calculation of the leverage ratio.

The decision to relax the capital requirements has been widely viewed as key to calming what had been tumultuous Treasury markets in the early days of the COVID-19 pandemic. A need for cash had caused a massive sell-off in the bond market that the Fed helped to cover through its liquidity programs.

The supplementary leverage ratio is a product of post-Great Recession banking reforms that sought to make sure banks didn't take too much risk. Fed officials worry that relaxing the ratio might encourage banks to load up on risky assets like junk bonds, which carry the same weight against reserve requirements as safer holdings. **B**