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DEPOSIT STRATEGY

Using Reciprocals to Maintain Deposit Stability

The most compelling speakers at Bank Director's annual Acquire or Be Acquired Conference in January were brutally honest: The rising interest rate environment means banks must work harder to maintain long-term, high-value relationships.

In presentations on maximizing franchise value to obtain the optimal bid, attracting and retaining core business customers was discussed as a key part of bank strategy.

Most bankers view local businesses as the core of their franchises. These relationships often include community leaders, sponsors of local youth sports organizations, housing council members and maybe even a bank's board members. However, retaining relationships with these local businesses is no easy task; plenty of other attractive investment options exist now that rates have risen.

How well a bank does at holding onto those relationships can spell the difference between value creation and destruction, and also impact its acquisition and growth prospects.

"Volatile" Deposits

Herein lies a challenge: While banks might view local business accounts as core, regulators can consider them "volatile" if they are too large. For example, payroll account balances can often exceed the \$250,000 Federal Deposit Insurance Corp. limit on

insured deposits, depending on the time of the pay cycle.

If an examiner believes a bank has too much of its deposit base in these volatile funds, it could be required to raise more capital, increase liquidity or even take more extreme action to reduce reliance on a specific business client.

The alternative — shrinking the asset base or selling — could remove a vibrant source of support and leadership from the community. Local communities and economies are negatively impacted when community banks are gobbled up by national institutions.

These views were echoed by Orvin Kimbrough, chairman and CEO of Midwest BankCentre, a \$1.9 billion community bank in St. Louis, Missouri. In the 2023 Conference of State Bank Supervisors Annual Survey of Community Banks, he stated: "All banks will be faced with challenges in raising and retaining deposits, as some consumers elect to move their accounts to the largest financial institutions deemed to be too big to fail."

That, Kimbrough added, can threaten the role of community banks as "the lifeblood of local communities."

The Role of Reciprocal Deposits

Fortunately, there's a solution that can allow banks to maintain deposit stability and those valuable relationships. Reciprocal deposit programs are designed to spread the concentration risk of large depositors across a wide swath of banks, providing participants with stable core deposits.

While regulators have typically allowed about 20% of reciprocal deposits to be considered core deposits, most banks do not tap into such programs. Some market participants have pointed to the current regulatory approach as the reason for banks' lack of interest in reciprocals and

have offered some interesting proposals.

In a recent opinion piece in *The Wall Street Journal*, "The FDIC Should Act Like a Real Insurer," former acting Comptroller of the Currency Brian Brooks challenged conventional regulatory wisdom by proposing that the FDIC charge higher premiums for banks that hold high uninsured deposit balances unless they use reciprocal deposit arrangements to lower their risk.

Reciprocal deposit programs can enable alternative deposit and funding strategies to help banks weather balance sheet volatility. They also can provide customers with greater comfort that a bank's deposit base will remain strong whatever comes its way.

Using reciprocal deposits also can help satisfy regulatory demands. The FDIC recently began requiring examiners to write up concentrations of uninsured deposits greater than 50% of the deposit base.

Next Steps

So, what steps can a bank take? Run stress tests to help the asset/liability committee and the board understand the relative stability of its deposit franchise and prepare for upcoming exams, which will focus more heavily on deposit funding and stress assumptions.

Local examination teams are challenged to ensure they don't miss significant problems, so they will likely investigate any outliers in your business as potential red flags. Be ready for intensive discussions about deposit decay and the appropriateness of the bank's asset and liability profile relative to its capital and liquidity reserves.

Innovative tools that help community banks capitalize on their strengths and minimize threats and instability will be critical in 2024. Now is the time for banks to leverage reciprocal deposit programs to diversify and stabilize funding.



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