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McKinsey on **Payments**

No time for U.S. bank complacency over liquidity compliance

Since the global financial crisis, liquidity regulations have made headlines and influenced banking agendas across the world. One in particular, Basel III's liquidity coverage ratio (LCR), raised speculation that gave U.S. banks cause to fear the consequences for their commercial deposits. Although that initial panic has faded, the risk today is that concern will give way to complacency. The LCR remains a misunderstood regulation and there are serious implications for banks of all sizes. Though the ruling affects retail and commercial deposits, this article focuses on the repercussions for commercial banks, which are more severe and more nuanced than the repercussions in retail.

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From panic to complacency

Until recently, banking industry stakeholders believed that liquidity regulations could have catastrophic consequences. In late 2014, *The Wall Street Journal* cited "more than a dozen corporate officials, consultants and bank executives" who claimed that the LCR "upends one of the cornerstones of banking." In August 2014, a global asset management firm determined that the LCR, alongside rising interest rates, could cause up to one trillion dollars to leave commercial accounts. A few weeks later, a representative from The Clearing House, an association of 24 large commercial banks, told a group of senior executives that eight of the top ten technology initiatives at its member institutions were focused on compliance rather than product innovation.

That sense of urgency has since diminished. Headlines continue to warn against the costs of increasing regulation, but many experts no longer believe that liquidity compliance will have such a big impact. Recent data from McKinsey's U.S. Payments Map indicate that the LCR could still cost American banks a total of $4.2 billion annually, or just under one percent of the net interest income collected by FDIC insured institutions in 2014. These outflows predomi-

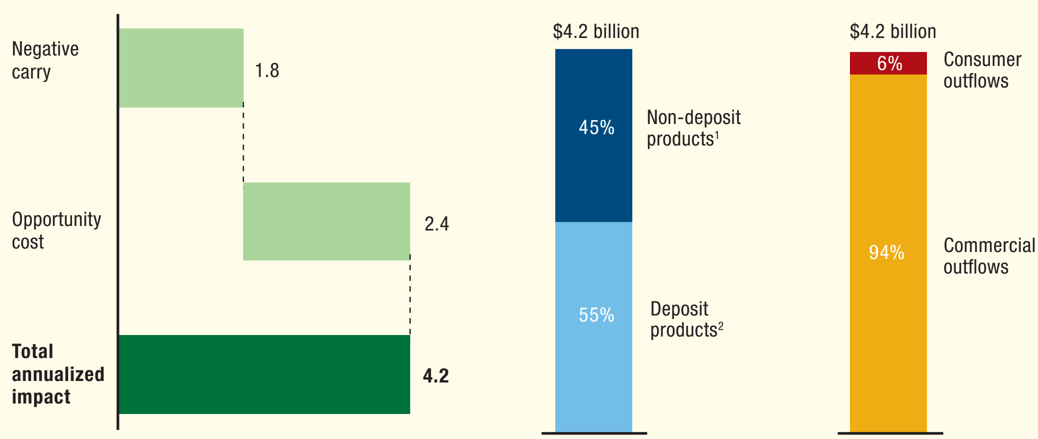
Exhibit 1

The majority of the impact of the liquidity coverage ratio results from costs associated commercial deposits

Annual revenue decrease due to LCR
$ billion

Loss associated with banking product
Percent

Loss associated with gross outflow
Percent



[1] Includes secured funding, credit and liquidity facilities, conduits, derivatives and other unsecure whole funding.

[2] Includes retail, small business, commercial non-operational and commercial operational deposits.

Source: McKinsey U.S. Payments Map; The Clearing House; Federal Reserve

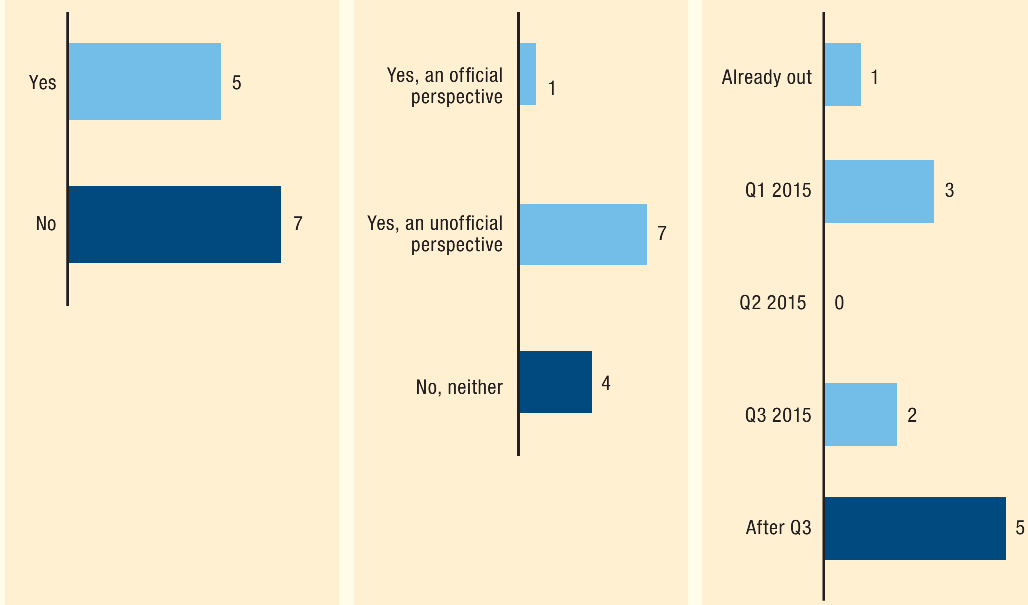
Exhibit 2

Many U.S. banks are still trying to formalize their approach to the LCR

Has your bank segmented its customers based on their LCR value?

Does your bank have an LCR perspective it shares with customers?

When does your bank roll out its official marketing material on LCR to clients?



Source: McKinsey/GCI participating quick poll banks, January 2015.

nantly affect commercial accounts, and more than half of the lost money will come from deposit products (Exhibit 1). Yet many decisionmakers have reacted to this information with uncertainty.

Most financial institutions have taken a cautious approach to the LCR ruling since its inauguration on January 1, 2015. When McKinsey surveyed 14 of the 35 LCR-eligible U.S. banks in January 2015, only one had an official strategic perspective on the ruling. Four did not even have an unofficial perspective. The same survey showed that nearly seven in ten banks had no plans to introduce their official LCR material to clients before the third quarter of 2015 (Exhibit 2). Capturing the state of liquidity compliance in July of this year, one policy expert remarked, "I don't think anyone knows precisely what this is going to do to the financial sector." In the absence of precise knowledge, most banks appear to be taking a "wait and see" approach.

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According to McKinsey's LCR survey, banks waiting to act do not anticipate changes to their products or strategy. Ten of the surveyed banks had no plans to change their earnings credit rate, a flagship interest payout designed to attract commercial deposits by discounting service fees. Nor did banks expect to push unattractive customers out by increasing their fees. Even growth expectations at the largest banks remained largely unchanged, despite the fact that banks below the LCR compliance threshold all indicated their intent to capture share from more regulated peers (Exhibit 3, page 42).

These signs of inertia among the largest banks suggest an ambivalence which should be corrected.

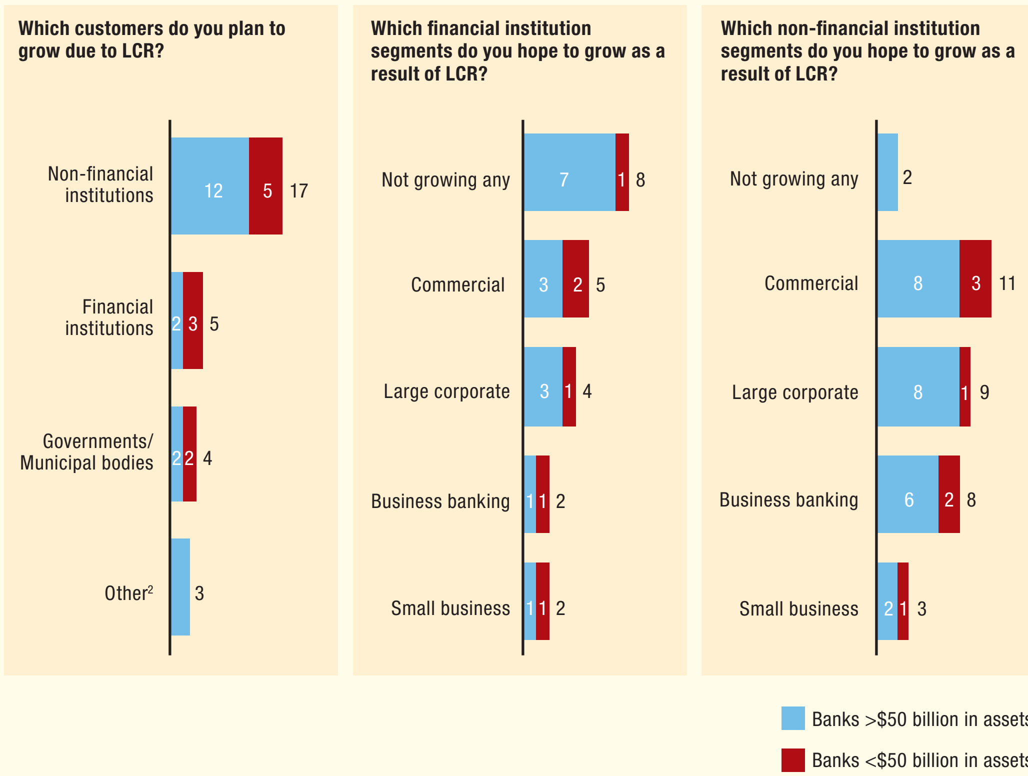
Different types of deposits affect bank revenues

The LCR is altering the U.S. deposits landscape and creating battlegrounds over attractive deposit types. At its core, the LCR seeks to prevent banks from lending balances that are subject to liquidity risk. The large majority of these at-risk dollars come from commercial accounts, since most retail balances fall within the $250,000 guaranteed by the FDIC. The LCR ruling, for instance, ascribes a runoff rate of just three percentage points to most retail deposits, meaning the bank can lend 97 percent of the funds in a retail account without penalty. For commercial deposits, however, the ruling ascribes average runoff rates of 40 percent, leaving just 60 percent for lending.

With regard to commercial deposits, regulators draw an important risk distinction between what they call "operational" deposits—cash unlikely to leave the bank in a liquidity crunch—and "non-operational" or "excess" deposits, though they leave the exact definitions for banks to define. Most banks surveyed by McKinsey agree that only funds flowing out of an account over a 30-day period are operational while everything else is "excess," or at-risk. From a bank's perspective, the profitability distinctions between operational and excess balances can be substantial.

Exhibit 3

Banks expect to grow large non-financial institution segments the most



[1] Other responses include "focused on transaction based customers of all types," "TBD" and "all segments"

Source: McKinsey/GCI participating quick poll banks, January 2015.

All else equal, operational deposits have a lower runoff risk than non-operational deposits, and, as a result, a higher proportion of these deposits are available for lending. Say a shipping company has $150 million in uninsured commercial deposits. Over the course of a month, its account incurs debits of $100 million. Under these circumstances, the $100 million is considered "operational" while the remaining $50 million would be excess. If business changed, and the shipping company's 30-day outflow dropped to $80 million per month, with $20 million now becoming excess, the bank would stand to lose $127,500 in revenues even though no deposits left the bank.[1]

Bank size determines the action needed

Ultimately, the LCR will create hurdles for banks of all sizes, but the height of these hurdles will depend on the size of the bank. Overall, 35 of the largest banks in the U.S. have been designated as systemically important and therefore subject to LCR compliance. Those with assets above $250 billion (12 banks in total) are recognized as "full-LCR" banks and have the most stringent regulatory obligations. "Modified-LCR" banks, the next tier of 23, hold assets ranging from $50 billion to $250 billion. New challenges will force these systemically important banks to break out of their inertia.

[1] This calculation assumes an interest rate of 5.25%, which equals the prime rate (3.25% as of July 2015) plus two percent, an industry standard, and a 1.00% cost of funds rate.

First movers below the LCR compliance threshold will benefit from the rule as their larger peers struggle to offset the impact of the regulation.

1. Small banks can capitalize on a structural pricing advantage

Initially, large banks risk losing unattractive (i.e., non-operational) commercial deposits from a subset of small to medium-sized enterprises (SMEs). Banks with assets of less than $50 billion—the criteria for exemption from the LCR—have two advantages. First, they avoid the incremental costs of developing and maintaining compliance infrastructure. Second, and more importantly, they can lend non-operational balances while their larger competitors cannot. This means small banks can extract more revenue per account than LCR-compliant banks, and thus they can offer more competitive discounts and better interest rates to attract new balances.

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In practice, the pricing advantage applies only to deposits from SMEs because many of the largest companies will be required to keep their deposits at large banks capable of supporting their global scale and complexity. The advantage furthermore accrues to just a subset of companies: those with large piles of non-operational cash. Small banks looking to capitalize on this structural pricing advantage should therefore target industries and companies that are least likely to attract competition from their larger peers. Small businesses (those with less than $1 million in credit exposure) receive favorable treatment under the LCR, which means they are attractive to the largest banks and thus subject to more competition. Smaller banks should therefore be wary of a blanket strategy that tries to grow share in all small business deposits. Instead, they should focus on SMEs in industries like professional services, where companies tend to have a high percentage of non-operational deposits, and avoid industries like manufacturing that do not. Small banks should also be wary of growing beyond the $50 billion asset threshold that triggers the need for LCR compliance. This suggests that, from an LCR perspective, tomorrow's true winners will have significantly less than $50 billion in assets today.

In order to maximize their market share, small banks will need to act quickly. As larger banks struggle to implement the full regulation by 2017, proactive smaller banks can take advantage of the change. Success depends on efficiently targeting the large bank customers most prone to churn.

2. Large banks can respond with product innovation, advanced analytics and strategic cross-selling

The news is not all bad for the largest banks. Those required to comply with the ruling can respond with three steps that together help regain some of the lost ground.

In the short term, banks can use product innovation to rescue revenue from existing accounts. The LCR freezes funds most likely to leave during a stress period, so leading banks have already begun to promote products that prevent account holders from withdrawing money during the 30 days monitored by the LCR. These products, including “31 day call deposits,” “putable CDs” and “hedge fund analyzed checking accounts,” are designed to reclaim balances frozen by the LCR.

Medium-sized banks should be wary of holding an untenable middle position as they battle for deposits. These modified-LCR banks can downsize to shed the regulatory burden, or upgrade to build large-scale infrastructure.

In the medium term, large banks can pursue innovative sales strategies that seek to grow the number of net new balances. One solution seeks to shift sales volume from in-field relationship managers to more agile “inside sales” forces. Inside sales forces consist of telesales people that cross-sell transaction banking products to small business owners. These largely commission-based teams cost less than their in-field counterparts and rely on complex pipelines initiated by branch employees and flagged by cross-sell algorithms. Since small business deposits are valuable assets from a liquidity perspective, sales teams that can win these deposits become increasingly important. Banks with large and efficient inside sales teams can quickly deploy them to capture small business deposits. Significantly, McKinsey’s LCR survey shows that banks underestimate the attractiveness of the small business segment. Only one in five banks surveyed in January 2015 had a desire to grow small business deposits. Commercial banks that embrace this segment as part of their strategy can outperform those who ignore it or let it fall to their colleagues in retail.

For the longer-term, banks can develop advanced analytical models that will eventually enable them to outperform those with less precise liquidity knowledge. Much of the confusion around the LCR stems from obscurities contained in the rule itself. Just as the rule does not formally distinguish operational deposits from excess deposits, it does not tell banks how to calculate the percentages assigned to any of these deposit categories. As banks build models to predict future deposit volumes through the lens of the LCR, those that can generate institution-wide liquidity reports and detailed cash flow predictions will have a much greater understanding of their business than a bank without such a system.

3. Medium-sized banks risk getting caught in the middle

While the three-part strategy outlined above applies in theory to both modified-LCR and full-LCR banks, in practice it privileges the largest players by virtue of their scale. Many full-LCR banks, for instance, already have large inside sales forces and advanced analytics teams while their medium-sized peers do not. Furthermore, large banks can upgrade their sales force and IT systems at a lower cost relative to their total operating expense. Medium-sized banks should thus be wary of holding an untenable middle position as they battle for deposits. These modified-LCR banks can downsize to shed the regulatory burden, or upgrade to build large-scale infrastructure. Those close to the $50 billion threshold may consider spinning off assets that keep them above the compliance limit. Alternatively, those intent on growth should realize that medium-sized banks can achieve the greatest return from their compliance investments because they are starting with less initial infrastructure.

Caught between competing narratives, many banks have remained undecided on the issue of Basel III's LCR.

Modified-LCR banks that seize the opportunity to build—or buy—rigorous analytical systems capable of projecting cash flows and computing liquidity ratios will achieve the forecasting advantages of their larger peers while retaining the small advantages that accrue to modified-LCR banks. (Modified LCR banks have two primary advantages over their larger peers. First, they get to work with a monthly reporting schedule, compared to the daily schedule of their larger peers. Second they have less stringent outflow requirements.) Similarly, those who invest in a competitive inside sales force will strengthen their position by emulating their larger peers. First movers can leap (or slide) from the no-man's land of the middle into a stronger strategic position. Over time, these better equipped banks will be able to grow business more efficiently. They can more effectively allocate resources, avoid costly cash purchases during liquidity crunches and make smarter loans.

These positive benefits will help large banks mitigate the additional costs of LCR, but they will not offset the total cost, even for the most proactive banks. At LCR-compliant institutions, cash management will be less profitable: the $4.2 billion annual loss spread across 35 eligible banks will mean that some lose hundreds of millions of dollars in deposit-funded lending revenue. The inertia that grips many banks today must give way to action as LCR requirements escalate to full force by 2017.

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Caught between competing narratives, many banks have remained undecided on the issue of Basel III's LCR. Most commercial banks have yet to define their strategic approach, despite the fact that the ruling came into effect earlier this year. With $4.2 billion in annual deposit revenues at risk, large banks required to comply with the regulation will be penalized for their inertia more than small banks, which benefit from their competitors' increased capital requirements. Banks below $50 billion in assets that exercise their structural pricing advantage will win deposits in the short term. Larger banks, especially those between $50 billion and $250 billion, must work to develop products, teams and systems that set the course for long-term growth.

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