In the 2019 CSBS National Survey of Community Banks, “cost of funds” (35.4%) was the highest-rated answer by 571 community banks to the question of “what is likely to have the biggest influence on profitability over the next 12 months” (see Chart 1). In a related question, nearly one-third of the community bankers ranked “core deposit growth” (22.8%) or “cost of funds” (8.2%) as the “single greatest challenge” facing their institutions.

Deposit growth and funding risks are clearly a priority for community banks. And how these banks respond to the strategic challenges of attracting and retaining core deposits is an issue of interest to regulators, policymakers and bankers themselves.
I joined William C. Dunkelberg, chief economist at the National Federation of Independent Business, Jonathan A. Scott, a professor at Temple University in a recent working paper to explore these issues in greater detail by taking the individual bank survey scores and matching respondents (where possible) with relevant call reports to integrate financial performance data into the analysis. This working paper is being released with this blog post. As a working paper, we welcome and appreciate comments and feedback on this ongoing research.
In this blog, I will explore one important finding from this research: examining answers to the question of “what is the most important impediment to attracting and retaining core deposits.”

Overall, market competition is the most important impediment to attracting and retaining core deposits, with nearly 92% of respondents rating it as “very important” or “important” in their ability to attract and retain core deposits. Digging deeper, this is also the case irrespective of bank size, urban versus rural, or geographic location (as defined by CSBS district boundaries).

The next two highest-rated factors impeding community banks’ ability to attract and retain core deposits are other market demographics and depopulation. Approximately 39% of respondents rated other market demographics as “very important” or “important,” and like market competition, there was no differentiation among respondents based on bank size, urban versus rural, or geographic location.

However, depopulation, the third-highest ranked factor overall, with roughly 30% of community banks rating it as “very important” or “important,” was far more important to bankers in rural areas (see Chart 2). There have been well-documented shifts in population from rural to urban locations, so it is not surprising to see this reflected in the CSBS survey, but it bears watching as this trend continues to develop.
Indeed, banks reporting depopulation as “very important” or “important” to attracting and retaining core deposits more frequently experienced negative asset growth during the previous year. Banks with asset growth less than -3% more frequently report depopulation as “very important” or “important” (46% versus 30% overall). Relatedly, these banks also more frequently report capital constraints as “very important” or “important” (29% versus 14% overall).

Moreover, the importance of capital as a constraint to attracting and retaining core deposits is also negatively associated with profitability. The least profitable banks (ROAs less than 0.50%) more frequently report capital constraints as a “very important” or “important” (25% versus 13% overall) impediment to attracting and retaining core
deposits. In contrast, the most profitable banks (ROAs greater than 1.75%) more frequently report capital constraints as “not important” (60% versus 48% overall).

Again, these results should not come as a surprise. Banks that experience declining deposits are typically purposefully shrinking their asset base and would tend to identify depopulation and capital constraints as critical factors in maintaining core deposits. Shrinking the asset base may help improve capital ratios, but it challenges a bank’s ability to maintain core deposits, profitability and franchise value.

Using the CSBS National Survey of Community Banks and the research included in the working paper cited above, I plan to write two additional blogs that highlight these secular changes that may be impacting the future funding model for community banks. The next blog will explore factors driving banks to follow a core deposit growth strategy versus those that pursue a loan growth strategy. Following that, an additional blog will examine wholesale funding strategies as they relate to funding and liquidity.

To comment on this working paper, please email me at: TSiems@csbs.org.