A Tale of Two Strategies: Core Deposit Growth Versus Loan Growth

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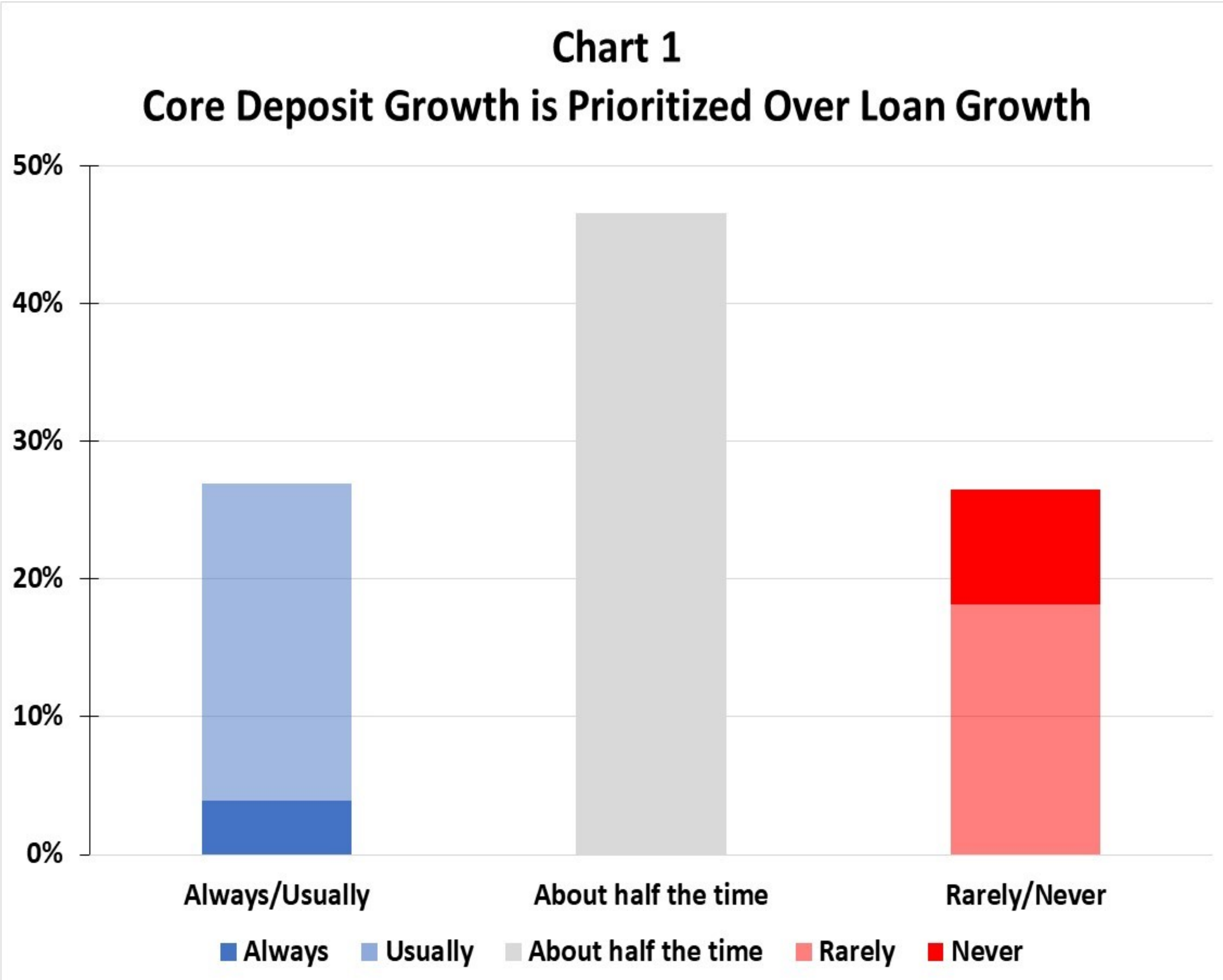
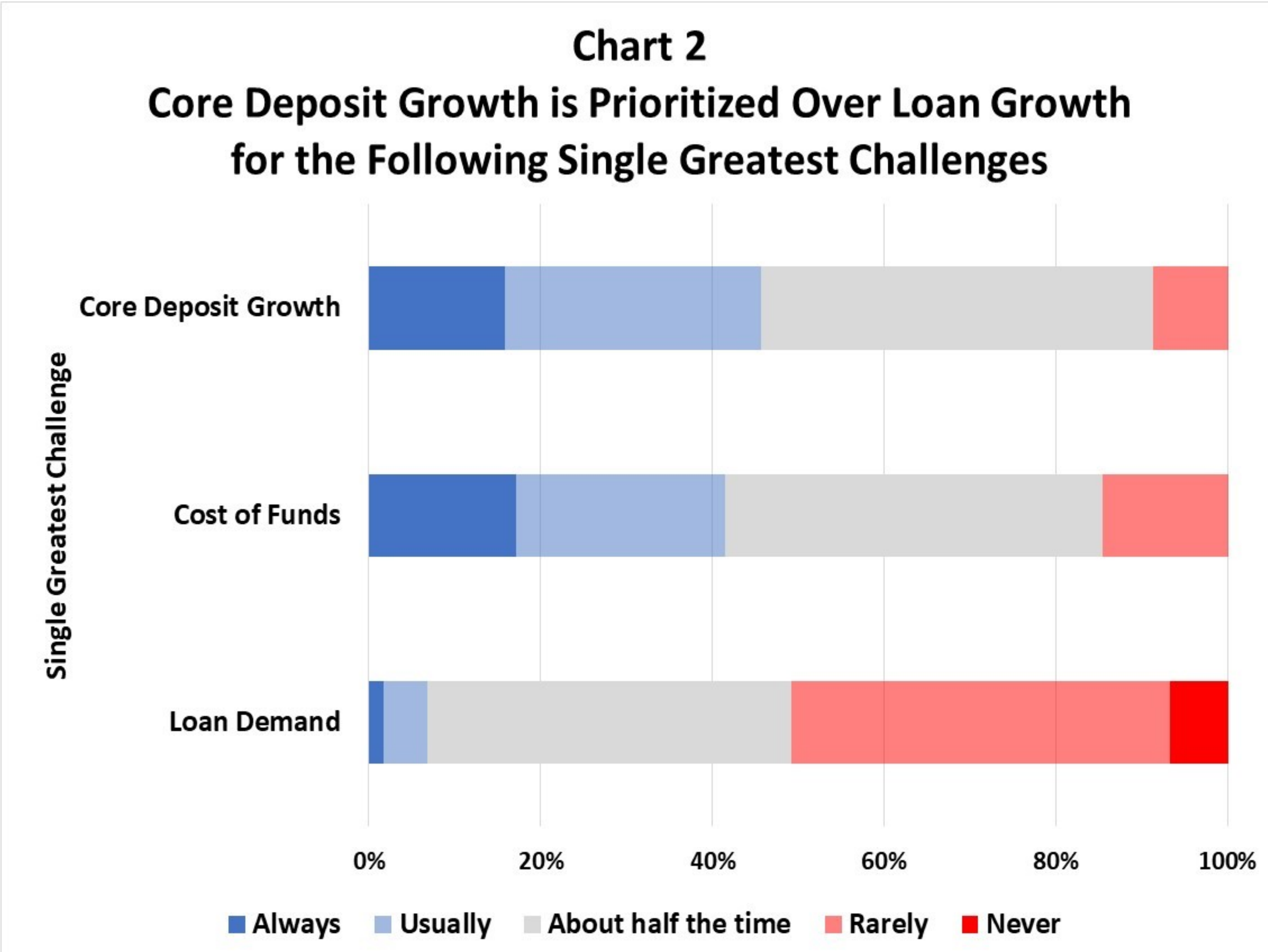
Funding concerns shift for community banks, and a close look at the 2019 CSBS National Survey of Community Banks shows the current focus is the importance of deposit growth and funding risks.

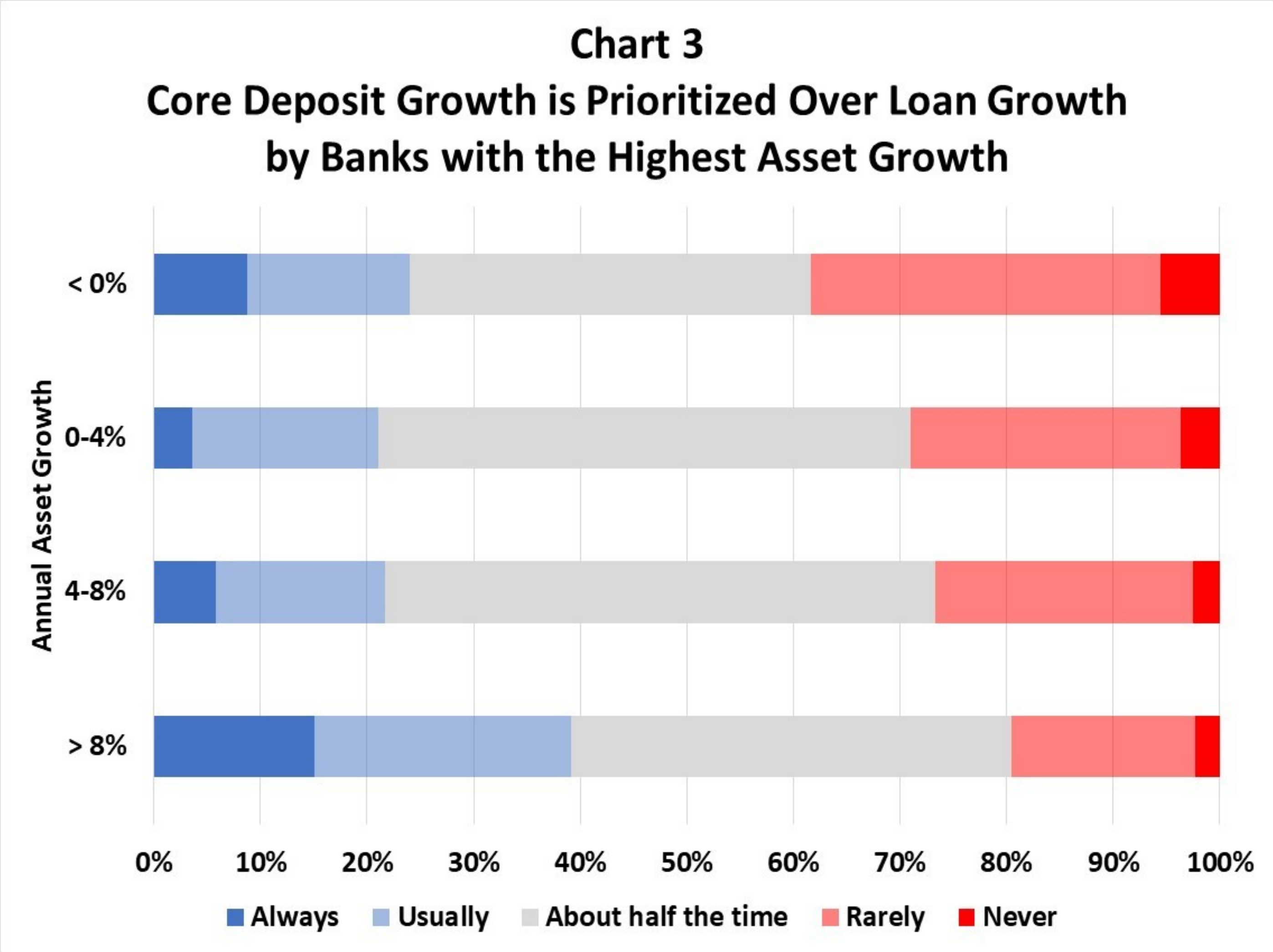
This year, 571 community banks responded to the annual survey. In answer to the question, “How often is core deposit growth prioritized over loan growth?” **Chart 1** shows that they were nearly evenly split between those that “always” or “usually” prioritize core deposit growth over loan growth (27%), with those that “rarely” or “never” do so (27%). The remaining respondents (46%) prioritize deposit growth over loan growth about half the time.



As shown in **Chart 2**, cross-tabulating these responses with another survey question reveals that of the 115 community banks (23% of respondents) that classified core deposit growth as their single greatest challenge, about 46% report that they “always” or “usually” pursue a core deposit growth strategy. Notably, concerns about the cost of funds is also strongly associated with banks that pursue a core deposit growth strategy. For the 44 banks (8% of respondents) citing cost of funds as their single greatest challenge, 41% “always” or “usually” pursue a core deposit growth strategy. Conversely, for the 62 banks (12% of respondents) reporting that loan demand is their single greatest challenge, 51% report that a core deposit growth strategy is “never” or “rarely” pursued.

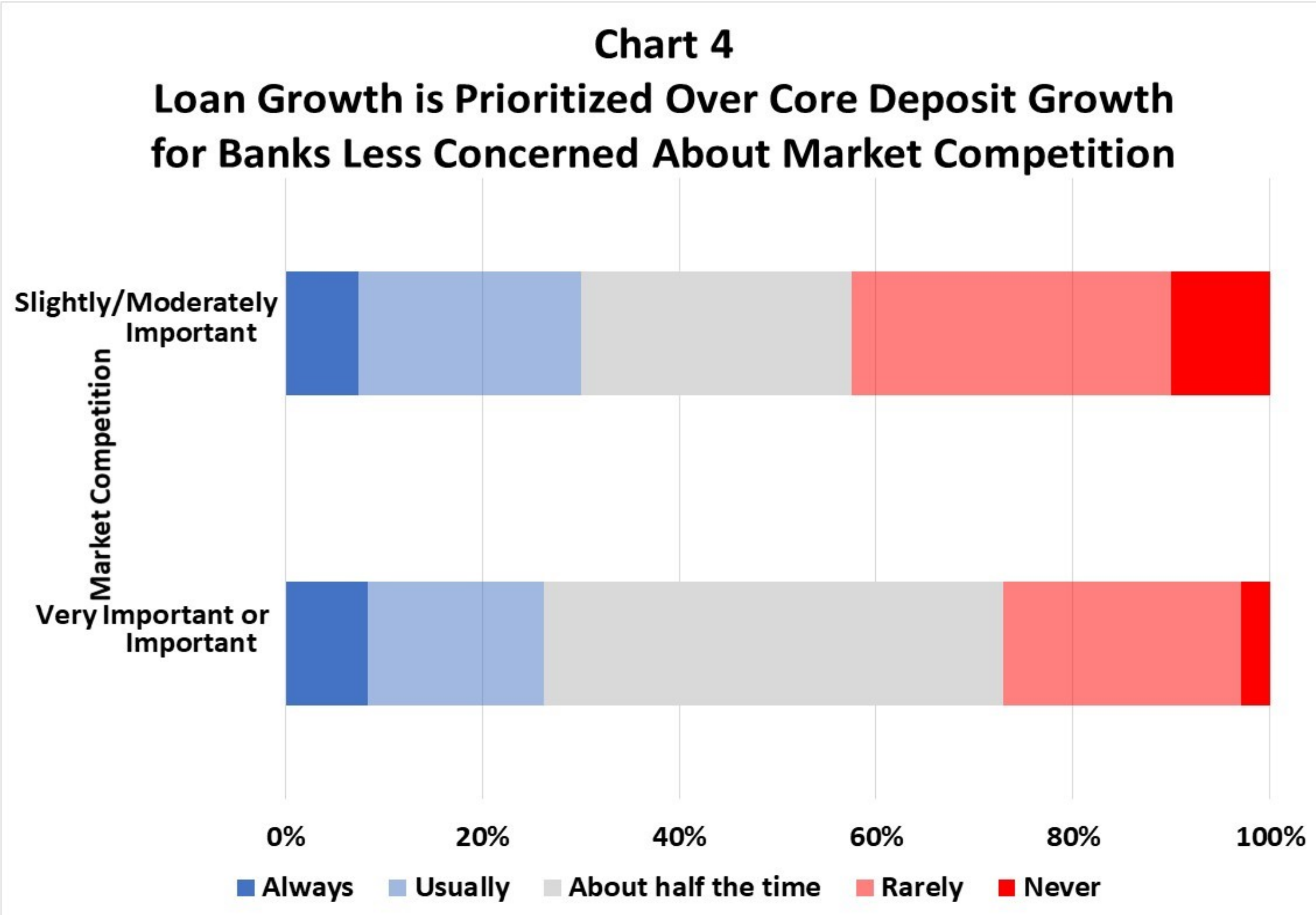


By matching individual bank survey scores with financial performance data on bank call reports, **Chart 3** shows that the highest asset growth banks, those with annual asset growth of at least 8%, more frequently report that core deposit growth is “usually” or “always” prioritized over loan growth (39% versus 27% overall). Likewise, core deposit growth is “rarely” or “never” prioritized for firms experiencing negative asset growth by 39% of community banks versus 27% overall.
This may suggest that rapidly growing banks are concerned mainly with liquidity and rely primarily on wholesale funding, thus the prioritization of core deposit growth to support asset growth. Shrinking banks, however, are likely more concerned about pursuing asset growth opportunities over sourcing core deposits.

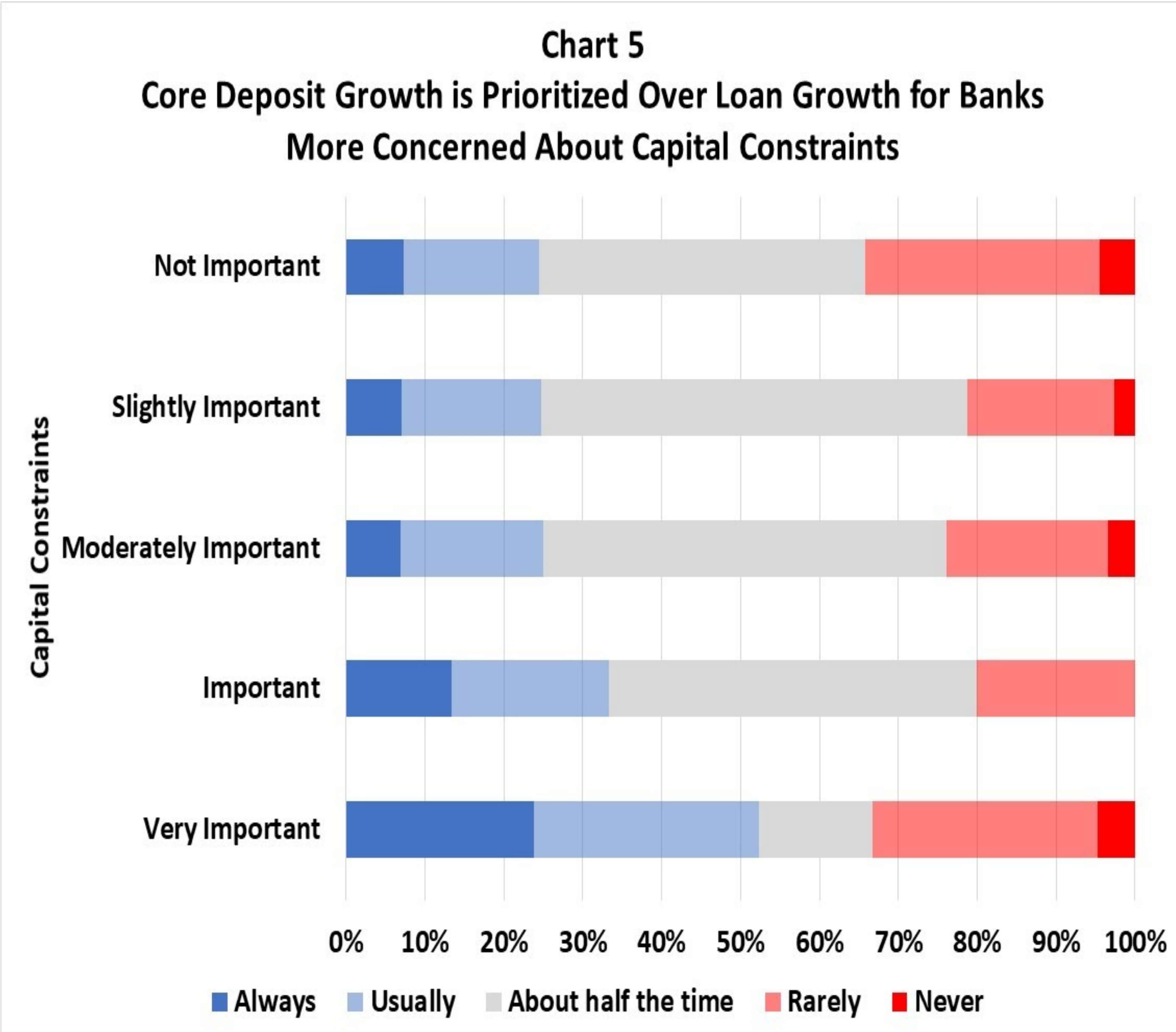


Two impediments to attracting and retaining core deposits, market competition and capital constraints, showed a strong association with community banks that prioritize core deposit growth over loan growth.

For banks that report market competition as “slightly” or “moderately important” as an impediment to attracting and retaining core deposits, **Chart 4** shows that they more frequently report that a core deposit growth strategy is “never” or “rarely” prioritized over a loan growth strategy (42% versus 27% overall). However, the converse is not true: banks that report market competition as an “important” or “very important” impediment to attracting and retaining core deposits do not more frequently report that a core deposit growth strategy is “usually” or “always” prioritized over a loan growth strategy. This may mean that less competitive markets have fewer growth opportunities and that these markets are losing deposits.



For banks that report capital constraints as an “important” or “very important” impediment to attracting and retaining core deposits, **Chart 5** shows that they more frequently report that a core deposit growth strategy is “usually” or “always” prioritized over a loan growth strategy (40% versus 27% overall). This may reflect the actions of banks with some constraints on borrowing (e.g., regulatory scrutiny) and the need to increase capital.



In summary, the 2019 CSBS National Survey of Community Banks revealed that an equal percentage of community bankers “always” or “usually” prioritize core deposit growth over loan growth to those that “never” or “rarely” do so. Not surprisingly, we find that community banks listing core deposit growth or cost of funds as their single greatest challenge tend to “always” or “usually” pursue a core deposit growth strategy. And conversely, community banks listing loan demand as their single greatest challenge tend to “never” or “rarely” pursue core deposit growth over loan growth.

We find that high asset growth community banks more frequently report pursuing a core deposit growth strategy, whereas negative asset growth community banks tend to prioritize loan growth. Finally, we find that community banks reporting that market concentration and capital constraints are important concerns regarding their ability to attract and retain core deposits more frequently prioritize core deposit growth over loan growth.

Community bankers and bank regulators are paying close attention to liquidity risks and higher loan-to-deposit ratios. A bank's core funding strategy should be forward-looking. That is, community banks that tend to prioritize core deposit growth should be most concerned about core deposit growth, and banks that prioritize loan growth should be most concerned about loan demand. These results are reaffirmed by this research and highlight some secular changes that may be impacting the future funding model for community banks.

This blog was the second post based on research from a recent CSBS working paper (co-authored with William C. Dunkelberg, chief economist at the National Federation for Independent Business, and Jonathan A. Scott, professor at Temple University). In the first post, community bank impediments to attracting and retaining core deposits was examined. Our next post will examine wholesale funding strategies as they relate to funding and liquidity.

We welcome comments on this research and the CSBS working paper, which can be directed to me at TSiems@csbs.org.