SCOPE Scope Ratings

European banks face disruptive retail funding dynamics

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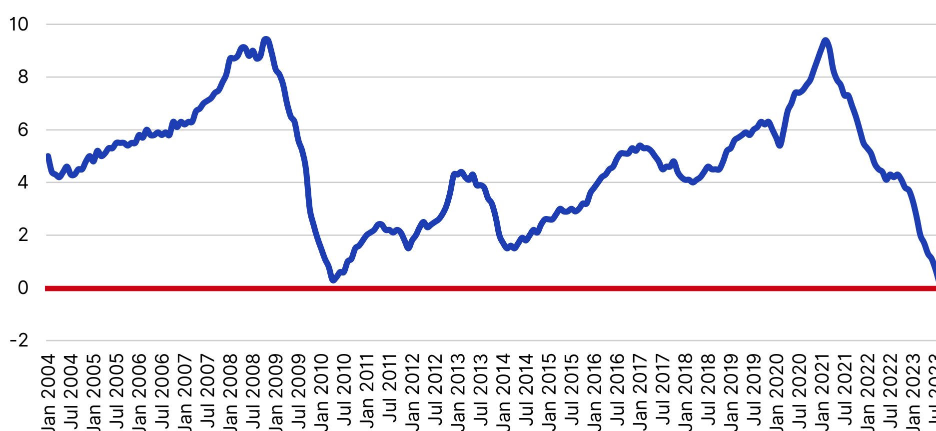
Rising interest rates and shrinking liquidity, the two most visible effects of the European Central Bank's tighter monetary policy, are having a major impact on the composition of European banks' balance sheets, including retail funding. Retail customers are seeking better remunerated products and the number of options has increased.

Deposits can move from non-remunerated to remunerated accounts, from on-balance sheet to off-balance sheet products, or can end up outside of the banks' remit altogether. The latter is more worrying for banks because by definition it means a potentially durable loss of funding sources.

In the short term, we believe the banks have the capacity to adapt. But for the banks most exposed to this trend, how they respond demands attention. Failure to stabilise the trend could have structural implications for profitability and asset-liability management, including rising loan-deposit ratios and a greater reliance on wholesale funding.

The latest ECB lending survey highlighted the new dynamics, referring to a pronounced deterioration in banks' access to retail funding, where 7% of banks said they are exposed to this trend (6% in the previous quarter), the highest on record since the first quarter of 2012. The Bank noted that this is especially the case for short-term funding (11%, after 14%) and "is consistent with the higher competition for liquidity stemming from other banks and from alternative investment opportunities with higher remuneration". Household deposits have reached a tipping point: for the first time in 20 years they have started contracting.

Figure 1: household deposits start contracting

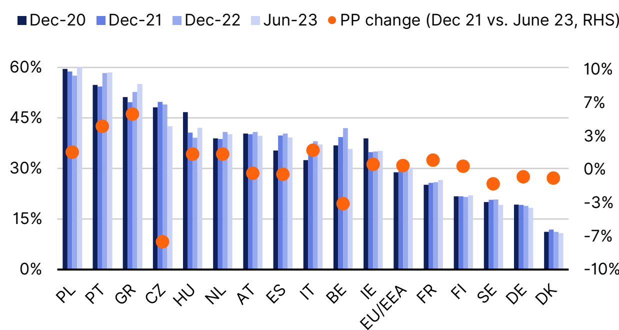


Deposits in M3 vis-a-vis euro area households reported by MFIs, central gov. and POGIs (post offices) in the euro area (annual growth rate) Source: European Central Bank

This is a fundamental change because access to cheap retail funding is a key component of European banks' business models and profitability. Household deposits represent the bulk of deposits used to fund loans.

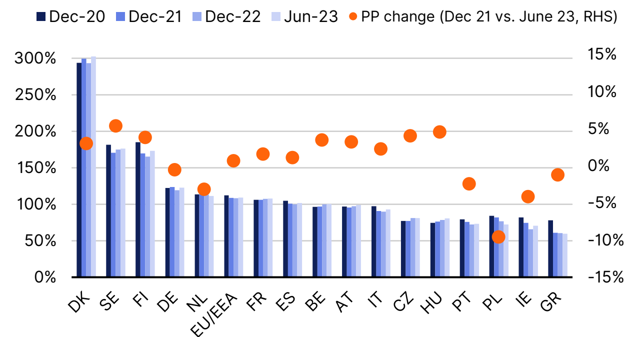
As of June 2023, household deposits (including demand deposits that pay zero or little interest) represented 30.3% of European banks' total funding (Figure 2). Deposits from corporates accounted for little more than half that number, 16.2%. Since the end of 2021, the loan-to-deposit ratio has risen in most countries (Figure 3). Preserving customer deposit bases has become paramount.

Figure 2: Household deposits, the lion's share of European banks' total funding



Ranking as of June 2023. Source: EBA risk dashboards

Figure 3: Loan-to-customer deposits ratio moving up



Ranking as of June 2023. Source: EBA risk dashboards

The starting point for banks is somewhat comforting, however, as they accumulated significant deposits in the low-for-long interest-rate period and during the pandemic in the form of precautionary savings. Demand for loans is also reducing due to tightening financial conditions and the economic slowdown.

Beyond being cheap, another important attribute of retail funding is its stickiness under normal circumstances. This can be explained by a third attribute: granularity. Retail funding is an amalgam of small deposits made by a large number of individual clients, often protected by deposit guarantee schemes. Because of customer habits and multi-product relationships, switching is relatively rare except for the most agile customers such as uninsured wealth management customers, as was the case with Credit Suisse.

Confidence and attractive pricing are vital conditions for retaining customer deposits. There is very little banks can do to prevent an exodus of deposits. What characterises the current trend is the growing customer focus on pricing. Deposit repricing has been earmarked as an indicator of fairness and banks have been put under the spotlight for being too slow to adjust rates on deposits. This argument is also being used with a political agenda to justify the taxation of banks' 'windfall profits'.

The most visible consequence of retail customers' search for yield is the transfer of funds to better remunerated accounts, in particular from demand to time deposits. This has a negative impact on net interest margins, hence profitability. But at the very least access to deposits as a source of funding is preserved. This shift can even be exacerbated by local market idiosyncrasies, for instance inflation-linked products such as the Livret A in France, which explains why French banks are not benefiting from rising rates as much as peers in other countries.

Banks are likely to continue facing an erosion in their stock of core customer deposits. This will be driven by two factors:

1. For more fragile retail clients, using deposits compensates for falling real disposable incomes. In the context of rising energy costs and inflation, some depletion of precautionary savings needs to be factored in. This trend could become more significant in case of a more prolonged economic slowdown. At the moment, employment is holding up well, though wage growth has lagged CPI.
2. For wealthier clients, withdrawing deposits from banks in favour of better remunerated products that are not necessarily managed by banking groups. In the low-for-long interest rate period, banks implemented strategies to channel excess deposits towards off-balance sheet investment products that generate fees and commissions. This objective becomes less of a priority if core customer deposits start to shrink and balance-sheet management becomes more challenging.

This will force banks to look for alternative sources of funding and these will likely be more costly. Optimising funding structures requires a constant fine-tuning of interest rates taking into account two opposing stakeholder demands. On one hand, investors are scrutinising banks' capacity to manage and ultimately delay the repricing of their deposit base and control the speed at which it takes place in comparison with loans.

On the other hand, depositors expect deposit rates to follow the general trend of interest rates. As rates go up, the opportunity cost of idle cash increases and so does the incentive for depositors to move.

New retail funding dynamics are disruptive for banks because they are coming on top of other significant changes, with a potential compound effect. First, factors affecting retail deposits around price sensitivity can easily be transposed to corporate clients.

Second, quantitative tightening is designed to reduce excess liquidity in the system so ultimately there will be fewer deposits around, regardless of what individual banks do to preserve their funding bases. The accelerated repayment of TLTRO III has dramatically changed banks' reliance on central bank funding. Other tools include changing the remuneration of reserves and revising asset-purchase programmes.

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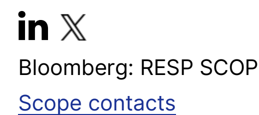
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