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Evolving Perspectives on Bank Deposits

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As a lending lawyer for more than a quarter century at this point, I have seen that deposit accounts and deposit account control agreements are a routine component of virtually every transaction. Deposit accounts are a source of high quality, easily realizable collateral for lenders in any secured loan transaction. However, following the regional bank crisis early last year, my perspective of deposits shifted. They were no longer simply another asset class of collateral for my bank clients. Instead, unfortunately, I saw first-hand how deposits are inseparably linked to the ability of our clients to not only make the loans we help them provide, but also to thrive as financial institutions.

Quick note: The Federal Reserve and other regulators are set to unveil revisions to a number of bank capital rules simultaneously with this edition (finalization of the Basel III framework, which includes the implementation of the remaining reforms that were agreed upon in December 2017). Be on the lookout for a Cadwalader summary of those revisions in the near future. This article will instead seek to provide a high-level overview of the reasons why banks need deposits, including their importance in offsetting capital reserve requirements and providing accessible funds to customers, as well as the role that deposits played in the 2023 regional bank crisis.

The Role of Deposits

Deposits are the lifeblood of any bank. They consist of money that customers place in checking accounts, savings accounts, and other deposit vehicles. Deposits are imperative for banks for many reasons, including:

1. **Liquidity Management**: Banks need to manage their liquidity to ensure that they can meet withdrawal demands from depositors. By holding deposits, banks have a stable source of funds that allows them to manage their cash flow efficiently and comply with regulatory liquidity requirements.
2. **Funding for Loans**: Banks primarily use deposits to provide loans to borrowers. When a bank receives a deposit, it can lend out a significant portion of those funds (typically around 90% or more, depending on reserve requirements). This relationship is the cornerstone of the fractional reserve banking system, whereby banks lend out more than they hold in reserves, generating profits through interest on loans.
3. **Cost-Effectiveness**: Deposits generally come at a lower cost compared to other funding sources such as issuing bonds or obtaining loans from other banks. Interest paid on depositors' savings accounts is often lower than the interest rates charged to borrowers, allowing banks to profit from the difference—this is known as the interest rate spread. Loans are on the assets side of the balance sheet (they provide a future economic benefit) and deposits are on the liabilities side of the balance sheet (they are what the bank owes others). During the regional bank crisis an asset-liability mismatch took place when the rate and tenure of maturing loans (assets) did not match the rate and tenure of the sources of funds/deposits (liabilities) – basically, the interest rate spread was negative.
4. **Risk Management**: Having a robust deposit base can help banks mitigate risks associated with market fluctuations and economic downturns. In times of economic stress, the stability provided by a strong deposit base can help banks weather financial storms better than those reliant on more volatile funding sources.

Background of the Regional Bank Crisis

The 2023 regional bank crisis can be traced back to several trends that developed in the preceding years. Following the COVID-19 pandemic, the U.S. economy experienced a significant rebound, leading to the not-as-transitory-as-we-thought rise in inflation, which caused the Federal Reserve embarked on the steepest rate hike cycle on record beginning in early 2022 and continuing into 2023. While the intention was to stabilize prices, this policy shift had unintended consequences for banks, particularly those that heavily relied on deposit inflows and low-cost funding (discussed above).

Key Factors Contributing to the Crisis

Rising interest rates, deposit outflows, asset-liability mismatch, regulatory environment and economic uncertainty all contributed to the crisis. For purposes of this discussion, however, the focus is on deposit outflows and how the rate hikes prompted depositors to seek higher returns on their savings elsewhere, particularly in financial instruments such as bonds or higher-yield savings accounts offered by various fintech companies and larger banks. Depositors seeking higher returns, combined with many other factors, such as the FDIC avoiding a "hard guaranty" of deposits above the $250,000 deposit insurance limit and the ensuing bank run for many of our clients led to significant outflows from regional banks. Those regional banks thus struggled to retain their deposit base and ultimately, a number of our regional bank clients faced insolvency, leading to emergency measures from federal regulators.

Deposits for Banks: Balancing Capital Reserve Requirements and Lending

While the flight of deposits was widely reported at the time (and attracted much more attention than factors such as asset-liability mismatch), what wasn't so clearly understood or reported was the reason why the flight of deposits was a primary factor that caused the insolvencies. In the realm of banking and finance, deposits play a foundational role in the functionality and stability of financial institutions. Deposits are not just a source of funding; they are essential for meeting capital reserve requirements and facilitating low-cost lending to borrowers.

Understanding Capital Requirements

Capital requirements are regulatory standards set by financial authorities to ensure that banks maintain a certain level of capital relative to their assets. This is done primarily to safeguard the bank against insolvency and to protect depositors. The capital consists primarily of the bank's equity and retained earnings, which act as a buffer against potential losses.

For example, in the United States, the capital adequacy framework requires banks to maintain a minimum common equity tier 1 (CET1) capital ratio of 4.5% of risk-weighted assets, among other requirements. This means if a bank has risk-weighted assets of $100 million, it must hold at least $4.5 million in CET1 capital. Maintaining this capital is crucial for the overall health of the banking system, as it enhances stability and fosters trust among consumers and investors.

The Interplay Between Deposits and Capital Requirements

Deposits and capital requirements are intricately linked. When a bank receives deposits, it not only establishes a source of funding for loans but also contributes to its overall capital structure.

Balancing Act

To remain compliant with capital requirements, banks must balance their active lending with their levels of deposits. An increase in deposits enhances the bank's ability to lend while simultaneously boosting its capital ratio, as the deposits contribute to the bank's asset side of the balance sheet. Conversely, a decline in deposits can lead to challenges in maintaining the capital ratios since reduced lending capabilities affect profitability and, consequently, surplus capital.

Stress Testing and Capital Adequacy

Regulatory bodies frequently conduct stress tests to determine if banks can maintain adequate capital levels during economic downturns. Having a strong foundation of deposits often results in better performance outcomes during these tests. Banks that maintain high deposit levels are generally viewed as more resilient and better positioned to absorb shocks without falling below required capital ratios.

The Impact of Technology on Deposits

In an era of digital banking, the way customers engage with banks is evolving. Online banking, mobile apps, and fintech innovation have transformed customer deposit behavior and preferences. While these technological advancements often lead to increased competition among banks for deposits—leading to potentially higher interest rates—they also open up new avenues for banks to attract and retain customers. However, at the same time, the regional bank crisis highlighted the new reality that the combination of social media plus depositor's electronic access to funds also resulted in deposits that could be withdrawn with a click of a button – resulting in large amounts of capital leaving the asset side of a bank's balance sheet in a matter of hours.

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In conclusion, deposits are essential for banks. They provide a cost-effective means of funding loans, help banks meet regulatory capital reserve requirements, and contribute to overall financial stability. In an increasingly digital and competitive landscape, the importance of effectively managing deposits cannot be overstated. As banks adapt to changing technologies and customer preferences, they must ensure that their deposit strategies remain robust and responsive. Ultimately, a strong deposit base is crucial not only for individual banks but also for the health of the financial system.