Understanding Bank Deposits

The Rate You See versus the Rate You Earn

InvestEd | November 2020

Public and nonprofit officials are expected to seek the best available returns while maintaining the safety and liquidity of funds when investing stakeholder dollars. However, that task can be challenging when comparing returns on cash on deposit with a bank against investment alternatives for those balances.

Many banks offer compensation to their institutional depositors through an earnings credit rate (ECR). This rate is typically set by the bank and determines the dollar value of credits earned on available or "compensating" balances. In most cases, earnings credits can only be used to pay the bank for services utilized.

When evaluating options for cash balances, it is important to understand the mechanics of the ECR offered. Due to bank fees and adjustments to the way ECRs are calculated, the actual return on deposits may not match the rate published on statements.

Stated ECR versus Effective ECR

In order to accurately compare the ECR relative to other alternatives, it is important to look not only at the stated rate but also at associated fees on deposit balances. Most banks assess a monthly fee on the value of deposits maintained. This deposit-based fee is identified on the monthly invoice or account analysis statement provided by the bank, with each bank using a unique name for the charge.

Examples of deposit-based fees include:

- Deposit Administration Fee
- Recoupment Monthly Fee
- Deposit Bank Assessment

Banks may also impose a reserve requirement, which can effectively reduce the balance available to generate earnings credits by as much as 10%. Deposit-based fees and reserve requirements should be considered because each can considerably decrease the effective earnings on bank deposits. In a low-interest-rate environment, fees on deposited balances may exceed the bank's compensation, resulting in a negative effective rate on balances despite the stated rate being positive. Consequently, it is important to compute the "net" ECR and compare the "net" rate to alternative investment options.

Earnings Credit on Compensating Balance		
Total Collected Balance		$25,000,000
Less Reserve Requirement	0%	$0
Available Balance		$25,000,000
Earnings Credit	0.25% $25,000,000 * 0.25 * 31/365	$5,308
Less Deposit-Based Fee	0% $0/($25,000,000 * (31/365)	$0
Net Earnings Credit	0.25% on Collected Balance	$5,308

For illustrative purposes only.

Earnings Credit on Compensating Balance		
Total Collected Balance		$25,000,000
Less Reserve Requirement	10%	$2,500,000
Available Balance		$22,500,000
Earnings Credit	0.25% $22,500,000 * 0.25 * 31/365	$4,777
Less Deposit-Based Fee	0.10% $2,123/($25,000,000 * (31/365)	$2,123
Net Earnings Credit	0.125% on Collected Balance	$2,654

For illustrative purposes only.

The tables above demonstrate the profound effect a deposit-based fee and reserve requirement can have on the generated earnings credit. The table on the left calculates an ECR with no deposit-based fee/reserve requirement. The bank's stated rate of 0.25% matches the effective rate on collected balances.

Meanwhile, the table on the right depicts an ECR impacted by a 10% reserve requirement and a deposit-based fee of approximately 0.10%. The bank's rate of 0.25% is drastically reduced to an effective rate of just 0.125% on collected balances.

COMPARISON TIPS

- Check to see if the bank is imposing a deposit-based fee (e.g., Deposit Administration Fee, Recoupment Monthly Fee, Deposit Bank Assessment).
- Inquire if the bank is imposing a reserve requirement. If so, remember that this lowers the balance available to generate earnings credits.

The Potential Risks of an Exceptionally High ECR

Some banks will offer above-market ECRs to incentivize customers to maintain large balances. This has the appearance of providing depositors a return that cannot be matched by alternative investments with similar safety and liquidity characteristics. However, in many cases, these exceptional rates are not fully realized by the depositor.

One notable risk related to an above-market ECR relates to the way banks set the rate in conjunction with pricing for cash management and treasury services. Because earnings credits can only be used to pay back the bank for services used, the bank can recover the "cost" of offering an exceptionally high ECR by raising the price charged for cash management and treasury services – effectively devaluing the earnings credit.

A second risk related to above-market ECRs is that the credits earned by depositors typically expire. While a depositor may accrue a large nominal value in credits, if the credits cannot be used to pay the bank for service charges before they expire, some portion will be lost – again devaluing the exceptional earnings credit. Depositors should monitor their monthly earnings credits against the cost of services utilized and be aware of how quickly any excess credits will expire.

How PFM Can Help

As you seek to fully understand your compensating balances and optimize your organization's earnings on deposit balances, PFM's experienced professionals can assist. PFM is a leading provider of investment advisory services to the public sector.

We are not affiliated with any bank or trust company; as fiduciaries, we provide independent, objective advice.

For more information about PFM, or any information in this article, please contact your local PFM relationship manager.