Understanding Compensating Balances: The Impact of Rising Interest Rates

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With the Federal Reserve raising interest rates, treasury departments may consider adjusting cash management strategies to take advantage of potential increased returns on deposits. **This changing economic environment highlights the importance of regularly evaluating the performance of cash held in depository accounts.**

Most 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.

> *Typically, **ECRs are not tied to any index or market rate**. Depositors should actively monitor rates and request rate increases from the bank when necessary.*

When evaluating options for cash balances, it is necessary to understand the terms of the ECR offered. Due to bank-specific fees and adjustments to the way earnings credits are calculated, the actual return on deposits may not match the rate published on statements. Understanding these provisions is key to effectively managing bank balances, regardless of the interest rate environment.

Stated ECR vs. Effective ECR

When comparing an ECR to other alternatives, it is important to look not only at the stated rate, but also associated fees on deposit balances. Most banks assess a monthly fee on the value of deposits maintained. This fee can be difficult to identify because it has a different name at each bank (i.e., Deposit Administration Fee, Recoupment Monthly Fee, Deposit Bank Assessment). The amount of this fee also varies by bank but can be as much as 0.15% or more on the value of deposits maintained.

Banks may also impose a reserve requirement, which can effectively reduce the balance available to generate earnings credits by as much as 10%. This practice dates back to the Federal Reserve's ("Fed") practice of requiring banks to set aside a portion of all deposits with the central bank. Many commercial banks removed their reserve requirement on deposits when the Fed began paying interest on required reserve balances in 2008. As of March 2020, the Federal Reserve waived its reserve requirement.[1] Despite these actions by the Fed, some banks still apply this requirement to institutional deposits.

Deposit-based fees and reserve requirements should be considered because each can decrease the effective earnings on bank deposits considerably. In a low interest rate environment, fees on deposited balances may even exceed the compensation paid by the bank resulting in a negative effective rate on balances despite the stated rate being positive.

[1] Board of Governors of the Federal Reserve System, March 15, 2020

Earnings Credit on Compensating Balance		
Total Collected Balance		**$25,000,000**
Less Reserve Requirement	**0%**	**$0**
Available Balance		**$25,000,000**
Earnings Credit	**0.50%** **$25,000,000 * 0.50% * 31/365**	**$10,616**
Less FDIC Assessment	**0.00%** **$0 / ($25,000,000 * (31/365))**	**$0**
Net Earnings Credit	**0.50% on Collected Balance**	**$10,616**

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	**0.50%** **$22,500,000 * 0.50% * 31/365**	**$9,555**
Less FDIC Assessment	**0.15%** **$3,185 / ($25,000,000 * (31/365))**	**$3,185**
Net Earnings Credit	**0.30% on Collected Balance**	**$6,370**

The tables above demonstrate the profound effect a deposit-based fee and reserve requirement can have on the earnings credit that is generated.[2] The table on the left calculates an ECR with no deposit-based fee/reserve requirement. The bank's stated rate of 0.50% 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 0.15%. The bank's rate of 0.50% is drastically reduced to an effective rate of just 0.30% on collected balances.

The Potentially Misleading Value of an Exceptionally High ECR

Some banks will offer above-market ECRs to incentivize customers to maintain large balances. While an ECR that is below short-term market rates may negatively impact your return on balances, a relatively high ECR may not be as advantageous as it first appears. One notable consideration for 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.

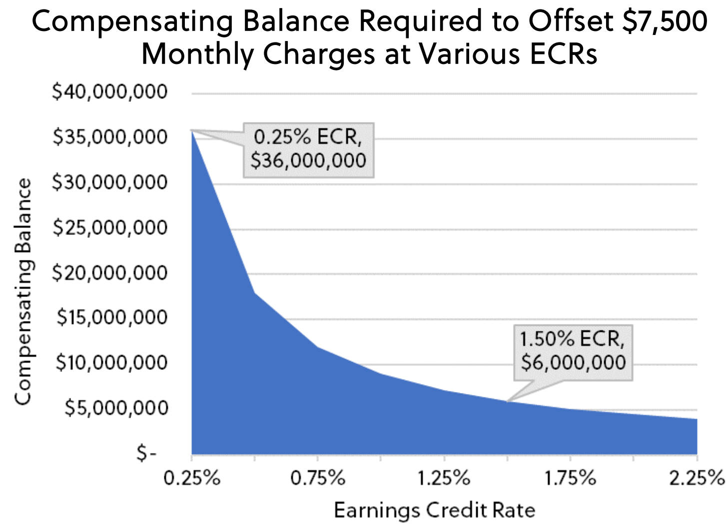
A second consideration related to above-market ECRs is that the credits earned by depositors typically expire. While a depositor may accrue a large nominal value in credits, if the credits cannot be used to pay the bank for service charges before they expire, some portion will be lost – again devaluing 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.

Bank Balances & the Interest Rate Environment

Generally, when money market fund yields are low (e.g., during the COVID-19 pandemic), taking advantage of an ECR can be a beneficial cash management strategy because banks have the ability to maintain rates slightly above ultra-low market rates. Low market rates may condition depositors to increase the amount they keep on deposit in order to take advantage of the beneficial ECR. However, **during a period of rising interest rates, lower bank balances may be sufficient to offset fees, freeing additional funds that can be transferred to investment vehicles with potentially higher yields than the ECR offered.**

[2] Data provided for illustrative purposes only.

The graph below demonstrates the level of bank balances required to offset $7,500 of monthly bank fees at various earnings credit rates.[3] At an earnings credit rate of 0.25%, the compensating balance required to offset fees is $36,000,000. Conversely, an earnings credit rate of 1.00% only requires $9,000,000 in balances to offset bank fees. Depositors should be prepared to actively manage bank balances as rates rise to ensure they are not earning excess credits that cannot be used.



Key Concepts

- The effective return on bank balances is often different than the stated ECR
- ECRs that exceed short-term market rates may not be advantageous
- Depositors should review ECRs frequently and prepare to request increases as market rates rise

How PFM Can Help

As you seek to fully understand your compensating balances and to optimize your organization's earnings on deposit balances, PFM's experienced professionals can assist. PFM is a leading provider of treasury consulting 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 the topics discussed in this article, please contact treasuryconsulting@pfm.com.[4]

[3] Data provided for illustrative purposes only.
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