

CADWALDER

Evolving Perspectives on Bank Deposits

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By **Kurt Oosterhouse**
Partner | Fund Finance

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.

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.

Greetings From Portugal

September 20, 2024



By **Wes Misson**
Partner | Fund Finance

The FFA held its annual Global Leadership Summit this week at the Pine Cliffs Resort in Albufeira, Portugal. Set atop a scene of cliffside ocean vistas and perfect weather, some of the top leaders in the industry across banks, fund sponsors, law firms and other service providers gathered to share thoughts on the current and future state of the global fund finance market.

While many of the sessions adhered to “Chatham House Rules”, there are a number of general themes and predictions to be shared beyond the walls of the Pine Cliffs ballroom: the most dominant of which included increased borrower demand, a better fundraising environment, alternative liquidity providers, structured solutions bringing together traditional fund finance technology with capital markets innovation, and the inevitable impact that AI will have on all participants.

Headlining the keynote speaker slate were Pippa Malmgren, an economist who advised U.S. President George W. Bush during Enron and 9/11 among many other international economic policy and private ventures, and Mo Gawdat, a former Chief Business Officer of Google and international best selling author and podcast host on the topic of AI and tech innovation.

The FFA also conducted a survey of conference participants, the results of which became a point of discussion and provide directional guidance for the near term future of our market:

Q1. There remains a liquidity squeeze affecting the Fund Finance market.

1% Strongly Agree

36% Agree

27% Don't Know

51% Disagree

7% Strongly Disagree

Q2. We are expecting to see an increase in activity in the Fund Finance market in the next 12 months.

21% Strongly Agree

64% Agree

15% Don't Know

1% Disagree

0% Strongly Disagree

Q3. Secondaries (both LP and GP led) are going to be more prevalent in the market in the next 12 months.

16% Strongly Agree

60% Agree

22% Neutral

2% Disagree

0% Strongly Disagree

Q4. Credit funds and non-bank lenders will continue to play an increasingly important role as lenders in the Fund Finance market.

38% Strongly Agree

47% Agree

13% Neutral

2% Disagree

0% Strongly Disagree

Q5. Regulation will have an impact on the products and/or availability of liquidity in the Fund Finance market.

26% Strongly Agree

45% Agree

22% Neutral

6% Disagree

1% Strongly Disagree

Q6. What will have the biggest impact on the Fund Finance market in the next 12 months?

9% Liquidity

15% Regulation

16% Macro-economic environment

41% Fund raising

4% Geo political environment

13% Interest Rates

2% Other

Q7. What are the fund structuring trends that will influence Fund Financing?

36% More open ended

8.5% More closed ended

30% More retail

23% More credit funds

5% Other

Q8. What trends are we likely to see in the development of Fund Finance products in the next 12 months?

18% More rated subscription facilities

13% More securitisations/structured products

10% More PE NAV financing

1% More warehouse facilities

58% All of the above

0% Other

Q9. Do you expect PE NAV products to increase in the market in the next 12 months?

84% Yes

16% No

Q10. Do you anticipate increased engagement from limited partners on PE NAV products?

86% Yes

14% No

Q11. What is the fund raising outlook for 2025?

5% Buoyant

38% Muted, but not as bad as some may expect

4% Depressed, with managers not holding fund raises until 2026

5% European market will be harder than US market

7% Middle East and Far East will be considered more than previously

38% Fund raising will be active for some strategies but not others

3% Other

Q12. Pressure from investors to generate liquidity has resulted in managers:

54% Setting up continuation vehicles

6% Selling assets

29% Entering into PE NAV facilities

5% Considering preferred equity solutions

6% Other

Q13. Generally, the trend in respect of PE Fund valuations is:

32% Generally, no write downs yet, but could be coming

12% Generally, certain assets are undervalued due to the macro-economic environment

46% There is difficulty in accurately valuing assets

9% No change – assets are still accurately valued and realizable at that value

1% Other

Q14. The trend in sponsor aggregation will continue and have an impact on the Fund Finance market.

86% Agree

14% Disagree

Q15. Technology will make the Fund Finance market and the provision of Fund Finance products more efficient across your organization.

71% Agree

29% Disagree

Of those participants responding to the survey, the breakdown was as follows:

15% Borrower of Capital

42% Provider of Capital

35% Legal Service Provider

8% Service Provider

Despite acknowledged challenges in the macro economic environment, geopolitical uncertainties and continued regulatory concerns, the overall tone was incredibly upbeat and noticeably more optimistic than last year's summit held at the Belfry, outside Birmingham, England. Perhaps it was the Portuguese sunshine and vino, or perhaps simply a statement of resiliency and innovation for a mature and growing industry that has overcome so much in the last two years. One thing is for certain: the state of our market is a reflection of its leaders - strong, driven, collaborative and incredibly committed to guiding us forward.

Please enjoy some of the pictures from the event. Obrigado to the FFA, its staff and all the sponsors.

Cadwalader Finance Forum – One Month Away

September 20, 2024



Join us on October 23 in Charlotte as we bring together the brightest minds in the industry for a one-of-a-kind event.

This premier event brings together industry leaders and experts for a day of networking and insightful discussions on the latest market trends and opportunities across various sectors, including commercial real estate, fund finance, leveraged finance, middle market lending, private credit, securitization and structured finance.

We look forward to welcoming you in October! You can learn more about the event and register [here](#).

Fund Fanatics Features Mark Lehmann

September 20, 2024



Join Scott Aleali, Head of Private Equity Finance at Citizens Bank, and Jeff Maier, Senior Managing Director - Private Equity Finance at Citizens Bank, with special guest **Mark Lehmann**, CEO of Citizens and President of Citizens California for the latest episode of Fund Fanatics!

They catch up on all things capital markets and the latest in market volatility.

You can watch it [here](#).

Fund Finance Tidbits – On the Move

September 20, 2024

CADWALADER FUND FINANCE 'ON THE MOVE'

The following individual(s) are on the move in the fund finance industry:



Jenna Hawke

Jenna Hawke joined Sumitomo Mitsui Banking Corporation – SMBC Group as an Analyst in Fund Finance Solutions. Prior to joining SMBC, Jenna worked as a Fund Finance Paralegal at Cadwalader, Wickersham & Taft, where she was a highly regarded member of the New York office.

Fund Finance Hiring

September 20, 2024

Fund Finance Hiring

Here is who's hiring in Fund Finance:

Coller Capital is seeking a Senior Associate, Investments, in New York. The key purpose of this role would be to participate in and contribute to all aspects of the deal process with responsibility for all primary quantitative and qualitative analysis of portfolio companies and funds. Learn more and apply [here](#).

L Catterton is seeking a Treasury Associate in Greenwich CT. The individual in this role would be the primary oversight for all fund and SPV level financing arrangements for all L Catterton Funds and more. Learn more details [here](#).

Bridge Bank is seeking a Portfolio Manager, AVP, in Boston, MA or San Jose, CA. This role would be responsible for an assigned portfolio of loan and/or deposit relationships. Learn more and apply [here](#).

Wells Fargo & Company is seeking a Fund Finance Analyst in London who will collaborate within integrated deal teams to drive the origination, structuring, and execution of fund finance transactions for top-tier financial sponsors and asset managers worldwide. If interested, you can apply [here](#).

Société Générale is seeking an Analyst who will be for supporting the origination and execution of Capital Call Financings and work with the portfolio manager to ensure efficient and timely management of annual credit reviews, monitoring of credit performance and industry trends. If interested, you can apply [here](#) or reach out to Laurie Lawler at Laurie.Lawler@sgcib.com.

M&T Bank is seeking a Commercial Relationship Manager in Boston, MA. This role would be responsible for an assigned portfolio of loan and/or deposit relationships with major businesses in the community. Learn more and apply [here](#).