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Analyzing Retail Banking Demand and Time Deposit Product

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Abstract

Deposits can be divided into two types. The first type is time deposits in which an account holder gives the bank money for a fixed period of time and therefore does not have any right to ask for money before the maturity date has been reached. On the other hand, there are certain types of deposits that a bank holds for which there is no maturity date. These are the types of deposits that can be withdrawn when required almost instantaneously. These deposits are called demand deposits and form a significant portion of the deposits that are held by a bank. Since these deposits are by definition unstable, the pose some very peculiar risks to the banks operations. In the studied that there are two types of deposits that banks use to fund their lending operations. I studied in detail about the different types of demand deposits. However, demand deposits are considered to be vulnerable sources of finance. Depositors are likely to pull out the funds that form a part of demand deposits at the slightest sign of trouble. To the contrary time deposits form a more stable source of funds. They form the solid foundation based on which banks can continue their lending operations. In this article, I will study about the various types of time deposits products that are offered by banks to their depositors.

Keywords: Retail Banking, Demand Deposit Product, Time Deposit Product, Economic management, Development Economics

1.0 INTRODUCTION

Banks in the modern world face an inherent risk of insolvency. Since the banks are so highly leveraged, there could be a run on the bank any moment if their reserves are considered to be inadequate by the market. Hence, banks must maintain adequate capital in their vaults if they want to survive. However, what constitutes "adequate" is subjective. This is generally measured in the form of a "capital adequacy ratio" and central banking institutions all over the world prescribe the level of capital that needs to be maintained.

2.0 DEMAND DEPOSIT PRODUCTS

2.1 Ensuring Solvency of Banks

The capital adequacy ratio is important from the point of view of solvency of the banks and their protection from untoward events which arise as a result of liquidity risk as well as the credit risk that banks are exposed to in the normal course of their business. The solvency of banks is not a matter that can be left alone to the banking industry. This is because banks have the savings of the entire economy in their accounts. Hence, if the banking system were to go bankrupt, the entire economy would collapse within no time. Also, if the savings of the common people are lost, the government will have to step in and pay the deposit insurance.

2.2 Limits The Amount of Credit Creation

Theoretically, reserve requirements are supposed to limit the amount of money that can be created by banking institutions. However, in some countries, like the United Kingdom and Canada, there is no reserve requirement at all. However, here too banks cannot go on creating unlimited money. This is because the capital adequacy ratio also impacts the amount of credit that can be created by the banks. Capital adequacy ratios mandate that a certain amount of the deposits be kept aside whenever a loan is being made. These deposits are kept aside as provisions to cover up the losses in case the loan goes bad. These provisions therefore limit the amount of deposits that can be loaned out and hence limit creation of credit. Changes to the capital adequacy ratio therefore can have a significant impact on the inflation in the economy.

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2.3 Credit Exposure

The capital adequacy ratios are laid based on the credit exposure that a particular bank has. Credit exposure is different from the amount loaned out. This is because banks can have credit exposure if they hold derivative products, even though they have not actually loaned out any money to anybody. Therefore, the concept of credit exposure and how to measure it in a standardized way across various banks in different regions of the world is an important issue in formulating capital adequacy ratios. There are two major types of credit exposures that banks have to deal with.

- Balance Sheet Exposure: Balance sheet exposure is the amount of risk that a bank is exposed to on account of the activities that are listed on its balance sheet. This would include the credit exposure that result from the loans that have been sanctioned. It would also result from the credit exposure that is the result of the securities that have been purchased by the bank. Hence an analyst can simply look at the balance sheet and come to an exact estimate of the credit exposure of any bank.
- Off Balance Sheet Exposure: On the other hand, there are some risky activities that a bank takes that are not listed on the balance sheet. For instance, bank may issue guarantees to some parties on behalf of some other parties. These guarantees are not financial transactions that can be listed on the balance sheet.

However, they do create credit risk in the process. Similarly, the bank may purchase derivative products which do not have any effect on the balance sheet today. However, they may expose the bank to significant amounts of risks. The amounts of catastrophic risks that can be caused by derivatives have been witnessed by the banks during the subprime mortgage crisis.

An analyst therefore needs to measure the credit risk that has been generated by off balance sheet activities. In order to accurately calculate the credit exposure that arises due to such risks, the analyst requires additional information from the banks.

2.4 Multi-Tiered Capital

For the purpose of calculating the capital adequacy ratio, not all the bank's capital is considered to be at an equal footing. The capital is considered to have a multi-tiered structure. Therefore, some part of the capital is considered to be more at risk than other parts. These tiers represent the order in which the banks would write off this capital if the situation to do so arises.

2.5 Risk Weighting

Also, all credit exposures of the banks are not considered at an equal footing either. Some of the liabilities of the bank i.e. demand liabilities and the loans that have been financed by them are far more dangerous than other liabilities. Hence, they need to be assigned appropriate risk weights. Using the system of weighted risks, banks can be more prepared regarding the probability of an adverse outcome and to meet the effects that such an outcome would have on the profitability and solvency of the bank.

3.0 TIME DEPOSIT PRODUCTS

3.1 Checking Accounts

A checking account is an account that is used primarily for transaction purpose. This means that the bank is also aware that the funds that are stored in these accounts will not stay there for long and hence do not count on them as sources of funds that are required to make loans. Checking accounts are called checking accounts because they allow account holders to have full check writing privileges. This means that account holders can write as many checks they need and no additional fees will be charged. However, account holders do not earn interest on the amount of money that they hold in a checking account. This is because banks cannot utilize these funds to earn an interest on them. Therefore, account holders have to pay the banks for the usage of such accounts since they are utilizing the depository as well as transaction services provided by the bank. Checking accounts are maintained by individuals in order to pay their bills. The money kept in this account is usually the amount of money that is required for liquidity purposes and generating interest is not the primary objective.

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3.1 Savings Accounts

In contrast to a checking account, a savings account is primarily maintained to save money. Therefore, the banks can be relatively certain that the amount of money in savings accounts form a relatively more stable source of funds. Of course, the funds can be withdrawn by the depositors in case they want to do so. However, most people do not withdraw their savings on a regular basis. Hence banks offer a relatively more attractive interest rate on these loans. Also, banks charge a wide variety of fees for withdrawal. The idea is to discourage people from withdrawing their cash for as long as possible. Savings accounts generally have a limited check writing facility. This means that the banks limit the number of checks that can be written in a particular period. If the account holder crosses this threshold, then they have to pay additional fee in order to write each check. Withdrawing from savings account therefore could prove to be a time consuming as well as costly affair.

3.2 Negotiable Order of Withdrawal (NOW)

A NOW account or a negotiable order of withdrawal is a type of account that was created with the primary intention of circumventing the regulation. The banking regulation in earlier periods prohibited payment of interest on demand deposits. However, other accounts like money market accounts did not face this restriction. As a result, banks were losing their business. To overcome this problem, the NOW account was created. The regulation stated that interest could not be paid on demand deposits but it could be paid on time deposits. Also, any deposit which had a maturity of longer than a week was considered to be a time deposit.

Banks created NOW accounts in such a way that they could theoretically ask for a 7-day notice from the account holder to withdraw funds if they wanted to. Hence they could term the deposits in a NOW account as time deposits and could therefore pay interest on the amounts deposited. However, in practice the banks never asked for any notice and the amount could be withdrawn instantaneously. Therefore, NOW accounts are in effect savings accounts that offer a slightly higher interest rate. Similar to saving accounts, NOW accounts offer a limited check writing privilege. Like savings accounts, if account holders decide to issue more than the allowed number of checks, it could soon turn into a costly affair.

3.3 Money Market Accounts

Money market accounts were created by banks in order to eliminate the competition being received from money market funds. Investors wanted the high return that money market funds had to offer. Therefore, banks started offering their own money market accounts which mimicked the returns generated by these funds. Also, banks provided additional liquidity. This is because banks allow account holders to write checks on their accounts and withdraw money without any transaction fees! However, a higher minimum amount of funds need to be maintained in a money market account. The amount of money that banks hold under money market accounts is not legally considered to be demand deposits. Hence, banks do not have to maintain reserves for such accounts making it the darling of bankers as well.

3.4 Certificate of Deposits

Certificate of Deposits or CD's as they are colloquially known are the most popular form of time deposits accepted by banks. They are promissory notes that are issued by the banks in lieu of the cash that they have received on account. This means that the bank borrows the money from you for a certain amount of time. Because the maturity of the fixed deposit is known, banks offer a higher rate of interest on them. This is because it is unlikely that the account holder will simply walk in and demand the money. Although, this is possible in case of time deposits as well that the account holder may want to make a withdrawal because of unforeseen circumstances. In such cases, the account holder can withdraw from their account but they may have to completely forego the interest and may also have to pay huge penalties. Certificates are available in several denominations. Certificates with face value less than $100,000 dollars are called small CD's whereas if the face value is greater than $100,000 they are called large or jumbo CD's. Corporations, banks and governments usually invest in jumbo CD's. It is unlikely for an individual to have that much money in a CD.

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3.5 Negotiable Certificate of Deposits

Negotiable certificate of deposits, are CD's which have one additional feature i.e. they have a liquid secondary market. Thus, a person can buy a CD from a bank. However, they do not have to lock in their funds for the entire period. In fact, they do not have to lock in their funds even for a day. These certificates can be sold immediately in the secondary market without any major loss of value. However, there may be some transaction costs incurred to sell the certificate and liquidate the money. The transaction costs will be considerably less than what it would cost to go to the bank and withdraw the money after foregoing the interest and paying the penalty.

3.6 Escalating Certificate of Deposits

Escalating certificate of deposit is a special kind of certificate that entices the account holder to keep their money invested for longer and longer periods of time. The bank does so by offering interest rate that goes on escalating each year. For instance, the CD might pay a 4% interest if the money is withdrawn at the end of the first year. However, if the money is not withdrawn, the interest rate may rise and go up to 4.5% for both the years. If the money is still not withdrawn at the end of the second year, the bank may further escalate the interest rate to 5%.

3.7 Index Linked Certificate of Deposits

There are some certificates of deposits which can offer investors returns based on the stock market. Thus, if the stock market moves up by a certain percentage so does the interest rate payable on the CD's. However, if the stock market goes down in value, then the minimum rate payable on the CD's would still be paid out as interest. Therefore, these kinds of CD's are very popular amongst investors who prefer to invest in the stock markets. Some of these CD's also allow investors with the option of switching over from stock market indexed returns to a fixed rate returns. When such options are embedded in the CD, the cost of the CD as well as the minimum investment threshold goes up. The more exotic securities are generally for the bigger investors.

4.9 CONCLUSION

Hence, since the government has a direct stake in the issue, regulatory bodies are involved in the creation and enforcement of capital ratios. In addition to that capital ratios are also influenced by international banking institutions.

The escalating interest rates obviously have to stabilize at some point in time. However, if the account holder has no immediate need of funds, escalating CD's are capable of ensuring that their money stays invested with the bank. These kinds of CD's are largely used by people who are saving for their retirement.

The market for certificate of deposits has also undergone a lot of innovation. Therefore, there are many CD's available today. Some of them offer higher returns whereas some others offer liquidity. Investors can choose amongst them based on the attributes that they consider most valuable.

Negotiable CD's are usually greater than $100,000 in face value. They are therefore bought and sold by large corporations. This adds even more liquidity to the market because these corporations move their money around often and hence there is a lot of buying and selling that goes around.

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