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Why Do Banks Want Our Deposits? Hint: It's Not to Make Loans.

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Many authorities have said it: banks do not lend their deposits. They create the money they lend on their books.

Robert B. Anderson, Treasury Secretary under Eisenhower, said it in 1959:

> When a bank makes a loan, it simply adds to the borrower's deposit account in the bank by the amount of the loan. The money is not taken from anyone else's deposits; it was not previously paid in to the bank by anyone. It's new money, created by the bank for the use of the borrower.

The Bank of England said it in the spring of 2014, writing in its quarterly bulletin:

> The reality of how money is created today differs from the description found in some economics textbooks: Rather than banks receiving deposits when households save and then lending them out, bank lending creates deposits.
>
> . . . Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money.

All of which leaves us to wonder: If banks do not lend their depositors' money, why are they always scrambling to get it? Banks advertise to attract depositors, and they pay interest on the funds. What good are our deposits to the bank?

The answer is that while banks do not need the deposits to create loans, they do need to balance their books; and attracting customer deposits is usually the cheapest way to do it.

Reckoning with the Fed

Ever since the Federal Reserve Act was passed in 1913, banks have been required to clear their outgoing checks through the Fed or another clearinghouse. Banks keep reserves in reserve accounts at the Fed for this purpose, and they usually hold the minimum required reserve. When the loan of Bank A becomes a check that goes into Bank B, the Federal Reserve debits Bank A's reserve account and credits Bank B's. If Bank A's account goes in the red at the end of the day, the Fed automatically treats this as an overdraft and lends the bank the money. Bank A then must clear the overdraft.

Attracting customer deposits, called "retail deposits," is a cheap way to do it. But if the bank lacks retail deposits, it can borrow in the money markets, typically the Fed funds market where banks sell their "excess reserves" to other banks. These purchased deposits are called "wholesale deposits."

Note that excess reserves will always be available somewhere, since the reserves that just left Bank A will have gone into some other bank. The exception is when customers withdraw cash, but that happens only rarely as compared to all the electronic money flying back and forth every day in the banking system.

Borrowing from the Fed funds market is pretty inexpensive – a mere 0.25% interest yearly for overnight loans. But it's still more expensive than borrowing from the bank's own depositors.

Squeezing Smaller Banks: Controversy Over Wholesale Deposits

That is one reason banks try to attract depositors, but there is another, more controversial reason. In response to the 2008 credit crisis, the Bank for International Settlements (Basel III), the Dodd-Frank Act, and the Federal Reserve have limited the amount of wholesale deposits banks can borrow.

The theory is that retail deposits are less likely to flee the bank, since they come from the bank's own loyal customers. But as observed by Warren Mosler (founder of Modern Monetary Theory and the owner of a bank himself), the premise is not only unfounded but is quite harmful as applied to smaller community banks. A ten-year CD (certificate of deposit) bought through a broker (a wholesale deposit) is far more "stable" than money market deposits from local depositors that can leave the next day. The rule not only imposes unnecessary hardship on the smaller banks but has seriously limited their lending. And it is these banks that make most of the loans to small and medium-sized businesses, which create most of the nation's new jobs. Mosler writes:

> The current problem with small banks is that their cost of funds is too high. Currently the true marginal cost of funds for small banks is probably at least 2% over the fed funds rate that large 'too big to fail' banks are paying for their funding. This is keeping the minimum lending rates of small banks at least that much higher, which also works to exclude borrowers because of the cost.

The primary reason for the high cost of funds is the requirement for funding to be a percentage of the 'retail deposits'. This causes all the banks to compete for these types of deposits. While, operationally, loans create deposits and there are always exactly enough deposits to fund all loans, there are some leakages. These leakages include cash in circulation, the fact that some banks, particularly large money center banks, have excess retail deposits, and a few other 'operating factors.' This causes small banks to bid up the price of retail deposits in the broker CD markets and raise the cost of funds for all of them, with any bank considered even remotely 'weak' paying even higher rates, even though its deposits are fully FDIC insured.

Additionally, small banks are driven to open expensive branches that can add over 1% to a bank's true marginal cost of funds, to attempt to attract retail deposits. So by driving small banks to compete for a relatively difficult to access source of funding, the regulators have effectively raised their cost of funds.

Mosler's solution is for the Fed to lend unsecured and in unlimited quantities to all member banks at its target interest rate, and for regulators to drop all requirements that a percentage of bank funding be retail deposits.

The Public Bank Solution

If the Fed won't act, however, there is another possible solution – one that state and local governments can embark upon themselves. They can open their own publicly-owned banks, on the model of the Bank of North Dakota (BND). These banks would have no shortage of retail deposits, since they would be the depository for the local government's own revenues. In North Dakota, all of the state's revenues are deposited in the BND by law. The BND then partners with local community banks, sharing in loans, providing liquidity and capitalization, and buying down interest rates.

Largely as a result, North Dakota now has more banks per capita than any other state. According to a May 2011 report by the Institute for Local Self-Reliance:

Thanks in large part to BND, community banks are much more robust in North Dakota than in other states. . . . While locally owned small and mid-sized banks (under $10 billion in assets) account for only 30 percent of deposits nationally, in North Dakota they have 72 percent of the market. . . .

One of the chief ways BND strengthens these institutions is by participating in loans originated by local banks and credit unions. This expands the lending capacity of local banks. . . .

BND also provides a secondary market for loans originated by local banks. . . .

Although municipal and county governments can deposit their funds with BND, the bank encourages them to establish accounts with local community banks instead. BND facilitates this by providing local banks with letters of credit for public funds. In other states, banks must meet fairly onerous collateral requirements in order to accept public deposits, which can make taking public funds more costly than it's worth.   But in North Dakota, those collateral requirements are waived by a letter of credit from BND. . . .

Over the last ten years, the amount of lending per capita by small community banks (those under $1 billion in assets) in North Dakota has averaged about $12,000, compared to $9,000 in South Dakota and $3,000 nationally. The gap is even greater for small business lending. North Dakota community banks averaged 49 percent more lending for small businesses over the last decade than those in South Dakota and 434 percent more than the national average.In other states, increased regulatory compliance costs are putting small banks out of business. The number of small banks in the US has shrunkby 9.5% just since the Dodd-Frank Act was passed in 2010, and their share of US banking assets has shrunk by 18.6%. But that is not the case in North Dakota, which has 35 percent more banks per capita than its nearest neighbor South Dakota, and four times as many as the national average. The resilience of North Dakota's local banks is largely due to their amicable partnership with the innovative state-owned Bank of North Dakota.

Ellen Brown is an attorney, founder of the Public Banking Institute, and author of twelve books, including the best-selling Web of Debt. In The Public Bank Solution, her latest book, she explores successful public banking models historically and globally. Her 200+ blog *articles are at EllenBrown.com.*

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