The Bank Treasury Newsletter
The Chart Deck
September 2023

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THE BANK TREASURY NEWSLETTER

In This Month's Chart Deck

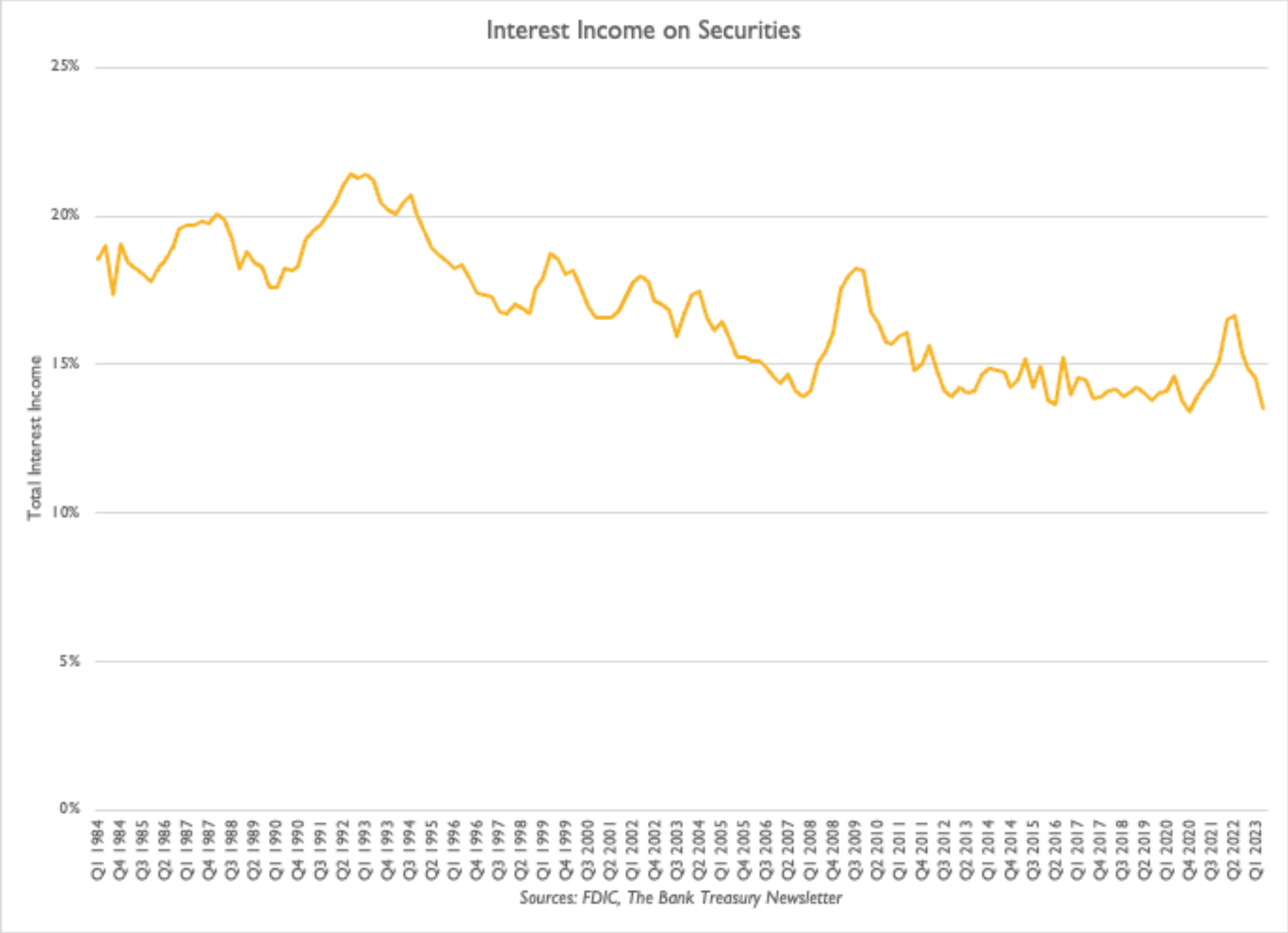
- The bank failures this past spring have called into question the wisdom of using a bank's bond portfolio as a source of liquidity. But recently, even as a source of interest income (see this month's newsletter), it has underperformed a cash portfolio. Nevertheless, FDIC quarterly income data released this month through Q2 2023 (Slide 4) show that a bank's bond portfolio has been a consistent contributor to interest income, averaging 17% of quarterly interest income since Q1 1984.
- The next four slides highlight the brightening story in the deposit space and easing liquidity strains since the disruptive fallout from the bank failures this past spring. During the summer, bank deposits trended up, and the latest message from bank management is that these trends are better than expected. Deposits sitting with the Large Bank peer group were flat since the end of Q2 2023, but notably deposits in the Small Bank peer group were marginally higher (Slide 5). Deposits exceeding loans, which equaled $4.9 trillion this month, 92% of which were concentrated in the Large Bank peer group, are down from over $7 trillion on the eve of quantitative tightening (QT) in June 2022, but are still $2 trillion higher than they were on the eve of Covid (Slide 6). Meanwhile, as deposit competition eases, bank treasurers are letting their Federal Home Loan Bank (FHLB) advances run off (Slide 7) and replacing some of the run-off with brokered CDs (Slide 8).
- With the Treasury still in the midst of a major refunding program, it has a keen interest in a stable market for its Bills, Notes, and Bonds, and so the final set of slides in this month's deck focus on the Treasury market and the primary dealers. QT is a key part of the equation for a stable market and its impact on bank reserve deposits during the last QT1 cycle in 2017-19 ultimately led to a major disruption in the Treasury repo market in September 2019. The SOMA portfolio shrank by $1 trillion since QT2 began in June 2022, down to under $7.5 trillion. Sharply higher rates have extended the Fed's System Open Market Account (SOMA) portfolio of Agency MBS securities, which are running off at half of the rate that the Fed had planned. As a result, with Treasurys running off at roughly $60 billion per month, SOMA's concentration in Agency MBS has been slowly increasing (Slide 9), setting up the Fed to have to choose between halting QT at some point, or having to sell Agency MBS to rebalance its SOMA.
- QT2, however, is a lot different than QT1, and one key reason is the Fed's Reverse Repo Facility (RRP). In QT2, for example, the Fed's RRP absorbed $0.6 trillion of the $1 trillion run-off from SOMA, and since QT2 began in June 2022, bank reserves increased by $101 billion through the middle of this month, to $3.1 trillion. By contrast, in QT1, a $0.6 trillion cumulative reduction in SOMA forced bank reserves down by 37%, to $1.5 trillion (Slide 10). As the Fed shrank its RRP it effectively pulled back from providing collateral in the repo market, and money market funds shifted cash to other repo participants. Even so, money market fund investments in the repo markets are down (Slide 11) . Some of the cash the funds had placed in the RRP may have come from sponsored repo. On April 25, 2023, the New York Fed changed the eligibility requirements for the RRP, concerned how sponsored repo may have led to increased concentration in primary dealers in the repo market (Slide 12). The final slide this month (Slide 13) is from the Fed's July 2023 survey of primary dealers, which found them generally pessimistic about the economy for the year ahead.

List of Slides

- Interest Income on Securities as a percent of Total Interest Income, *Sources: FDIC, The Bank Treasury Newsletter*
- Commercial Bank Deposits, *Sources: H.8 Report, Federal Reserve, The Bank Treasury Newsletter*
- Excess Deposits, *Sources: H.8 Report, Federal Reserve, The Bank Treasury Newsletter*
- Borrowings, *Sources: H.8 Report, Federal Reserve, The Bank Treasury Newsletter*
- Brokered Deposits, *Sources: Call Reports, FIS FedFis, LLC, The Bank Treasury Newsletter*
- Fed SOMA: Residential MBS, *Sources: H.4 Report, Federal Reserve, The Bank Treasury Newsletter*
- Fed Soma: Reverse Repo Facility, *Sources: H.4 Report, Federal Reserve, The Bank Treasury Newsletter*
- Money Market Investment in Repo, *Sources: Money Market Monitor, Office of Financial Research, The Bank Treasury Newsletter*
- Tri-Party/GCF Treasury Repo: Market Share of the 3 Largest Dealers, *Sources: New York Fed, The Bank Treasury Newsletter*
- Primary Dealer Survey: When Will The U.S. Enter Recession?, *Sources: New York Fed, The Bank Treasury Newsletter*

Bonds Have Consistently Contributed To Earnings

On average, through 158 fiscal quarters, bank bond portfolios accounted for 17% of the industry's quarterly interest income.



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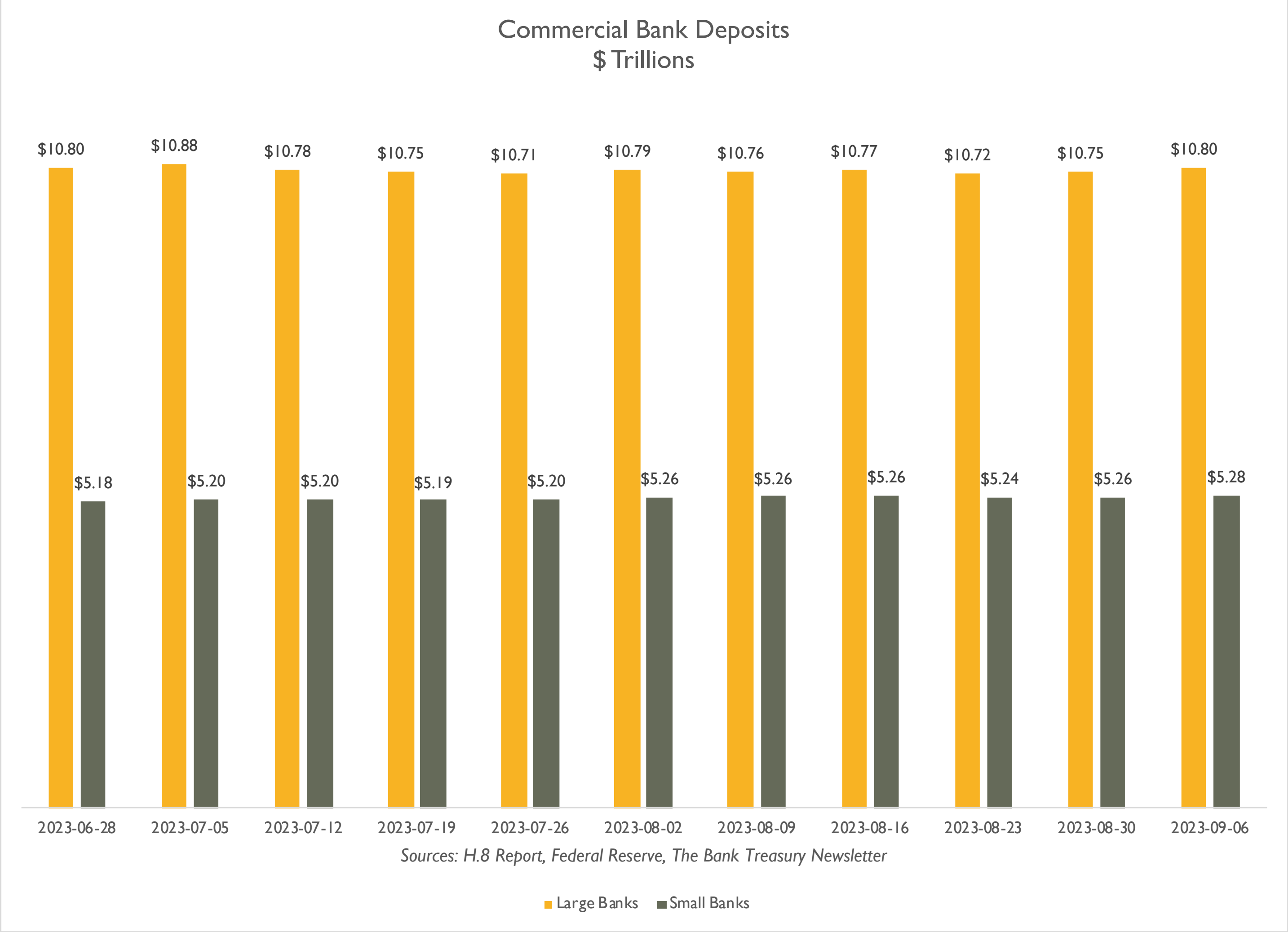
The Deposit Story Begins To Brighten Slightly

The H.8's large bank peer group deposits were flat through the first two months of Q3 2023, while the small bank peer group's deposits were up about 2%. Bank managers report an easing competitive landscape for deposit funding.



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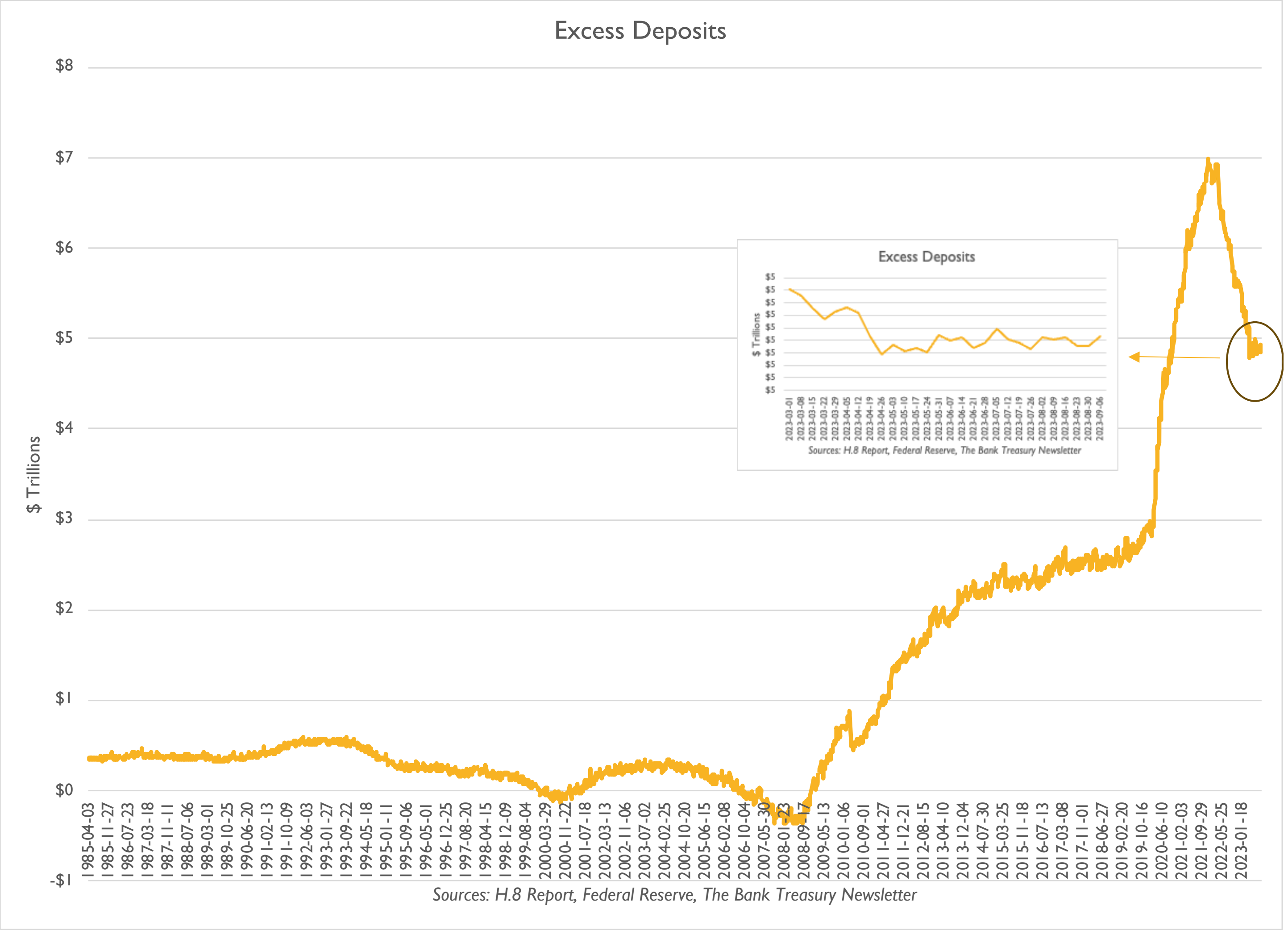
Excess Deposits Are Flat To Slightly Up

Excess deposits over loans came down sharply in the last year but are still way above historical pre-Covid levels. Of this excess, 92% sits at the largest banks. After the bank failures in March sparked a deposit outflow that lasted through the end of April, deposits subsequently stabilized, and loan demand also softened. These trends combined to hold excess deposits at $4.9 trillion into September.



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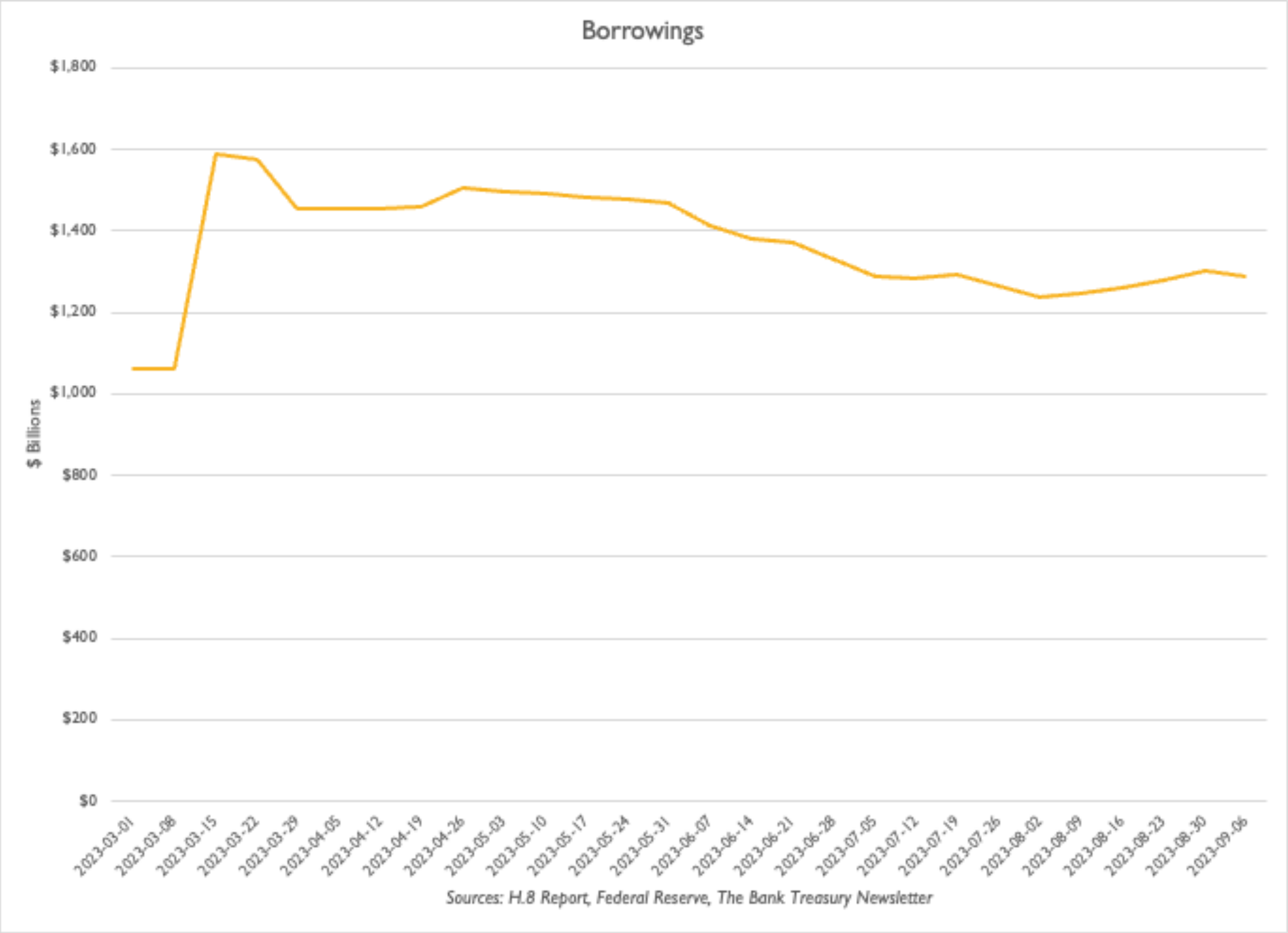
Banks Let FHLB Advances Run Off…

As the March crisis fades and the liquidity stress eases on their balance sheets, bank treasurers are letting some of their FHLB advances run off.



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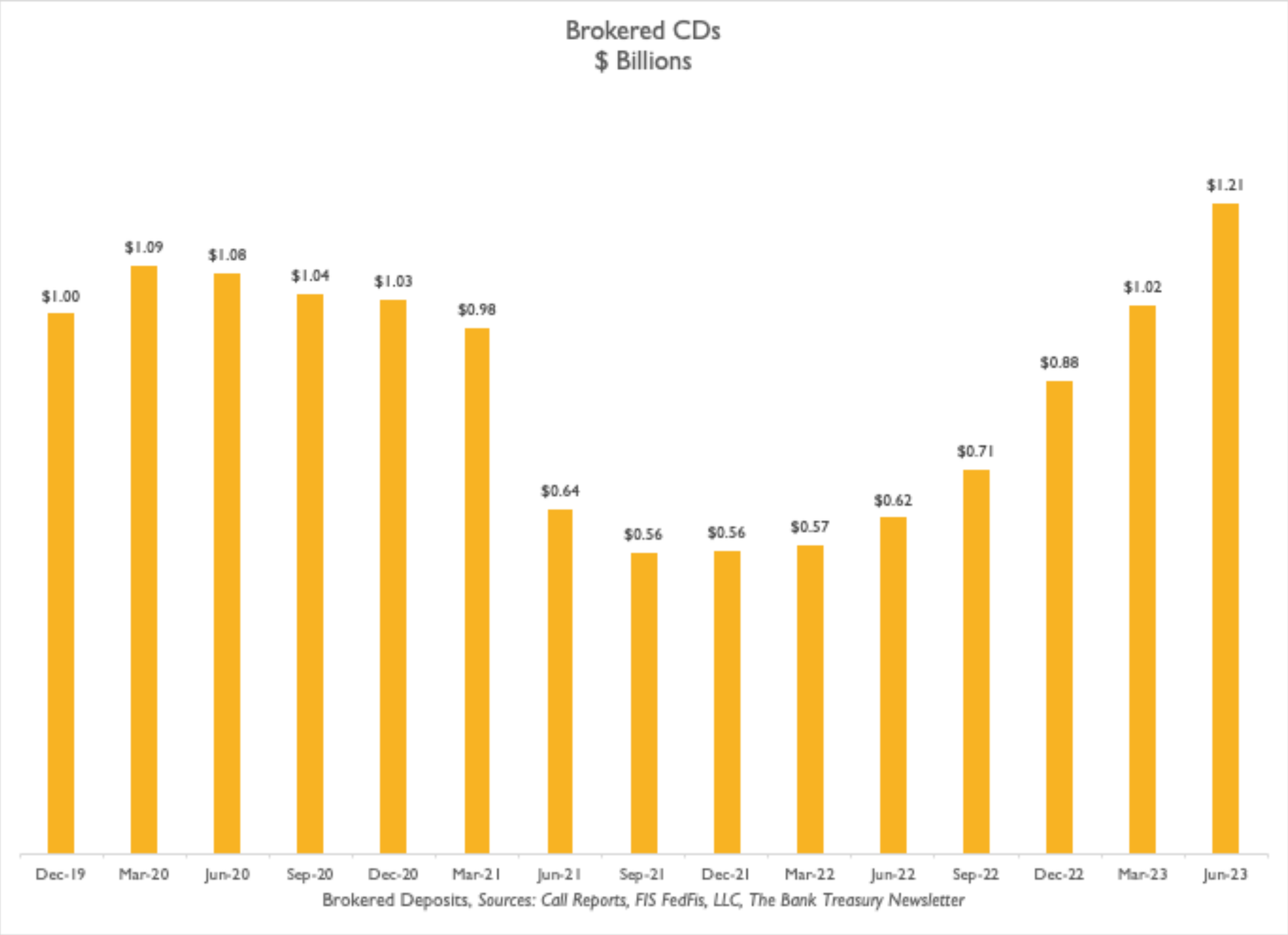
…And Replace Some With Brokered CDs

Bank treasurers view brokered CDs as an efficient liquidity tool to supplement their core deposit funding.



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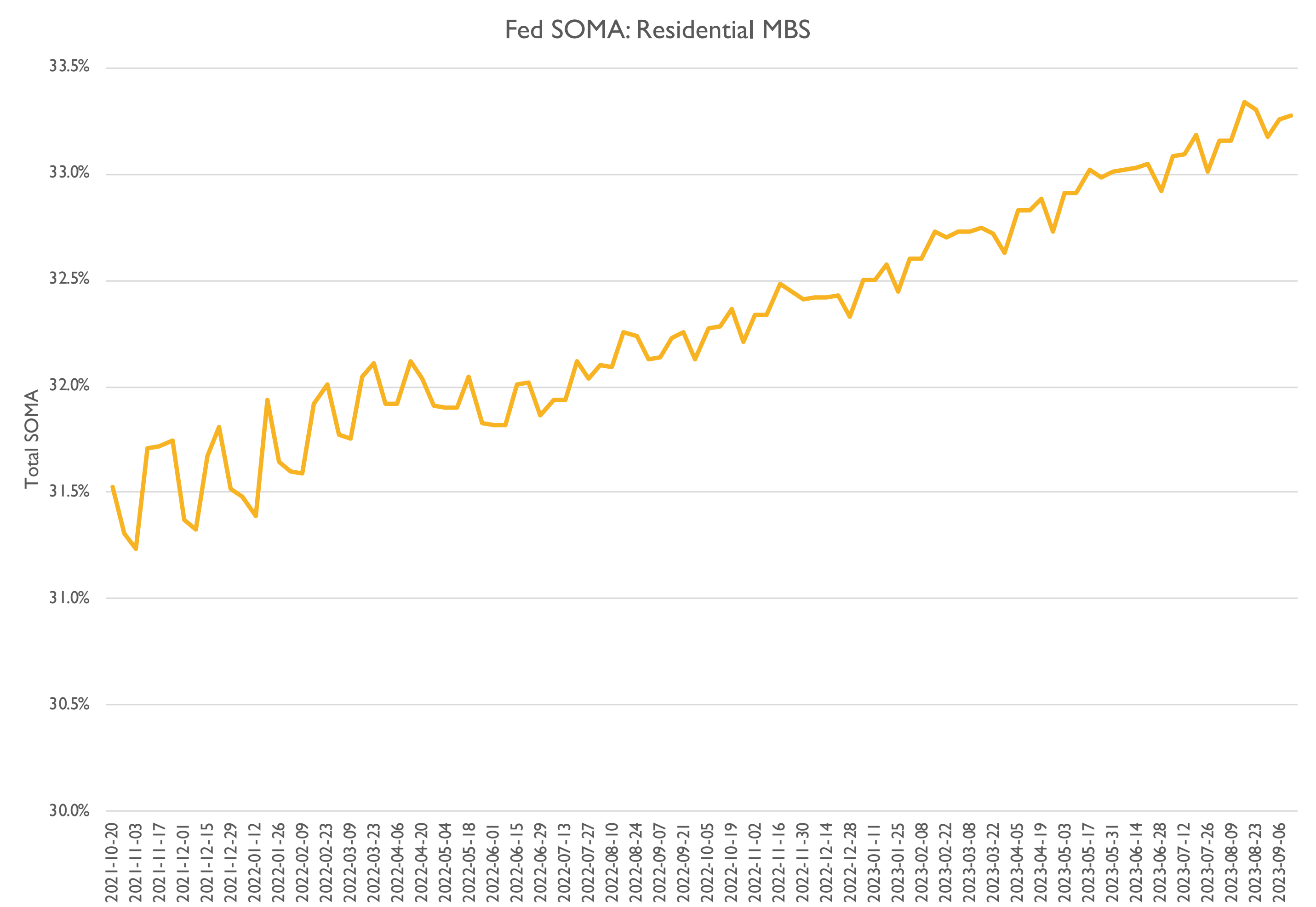
SOMA Gets More Convex

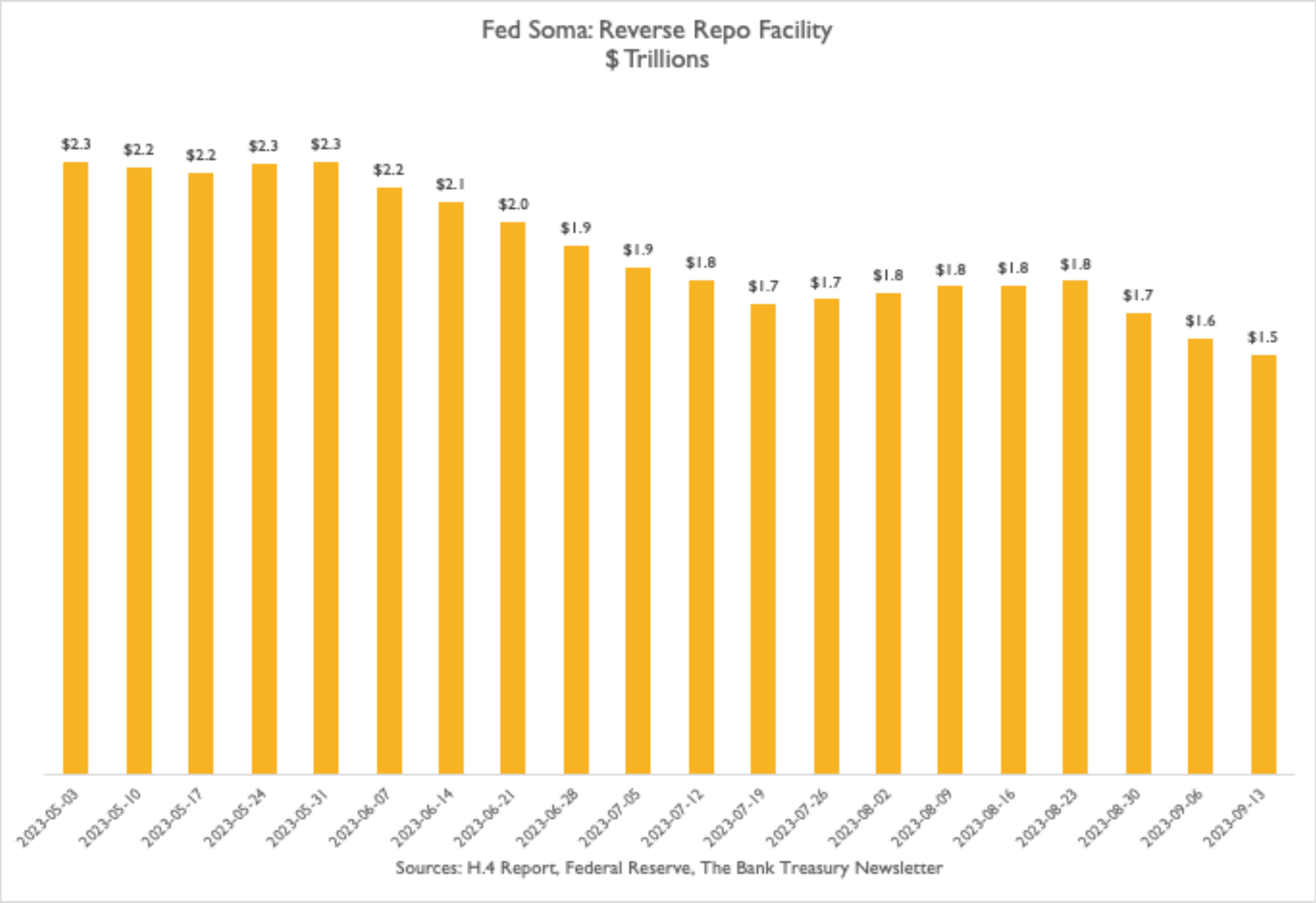
Since QT began in June 2022, the Fed's SOMA portfolio shrank by $1 trillion, to $7.5 trillion, of which Treasurys (excluding strips) fell by $0.8 trillion, to $5 trillion, and Agency MBS fell by $0.2 trillion, to $2.5 trillion.



Sources: H.4 Report, Federal Reserve, The Bank Treasury Newsletter

RRP Absorbs Most Of QT2

The RRP has played a critical role during QT2. During QT1 (2017-19), when the Fed did not have the RRP as a monetary policy tool, the Fed shrank its SOMA by $0.6 trillion, to $3.6 trillion, and balanced the reduction by cutting bank reserves by 34%, to $1.4 trillion. Using the RRP to balance 60% of the $1 trillion that ran off from SOMA in QT2, this month bank reserves are modestly higher, at $3.1 trillion, than they were when QT began 15 months ago.



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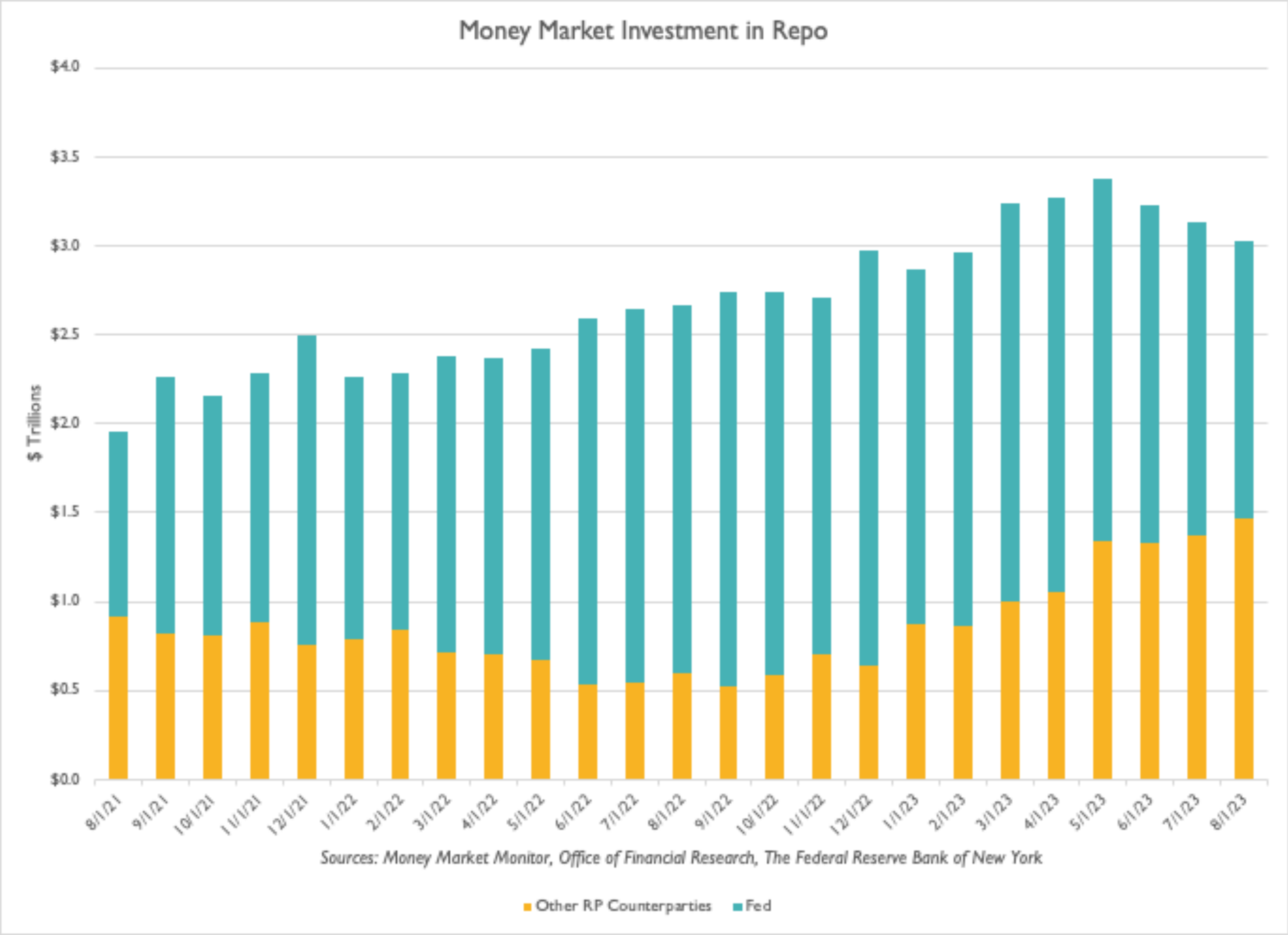
Money Market Funds Pull Back From Repo

The money market funds are a key provider of cash to the Treasury repo market. Meanwhile, the Fed, through its RRP facility, is a major collateral provider and a major counterparty with the funds. However, when the Fed reduced the RRP this year, the money market funds shifted some overnight cash to other repo counterparties. However, net-net, money market investment in Treasury repo fell this past summer.



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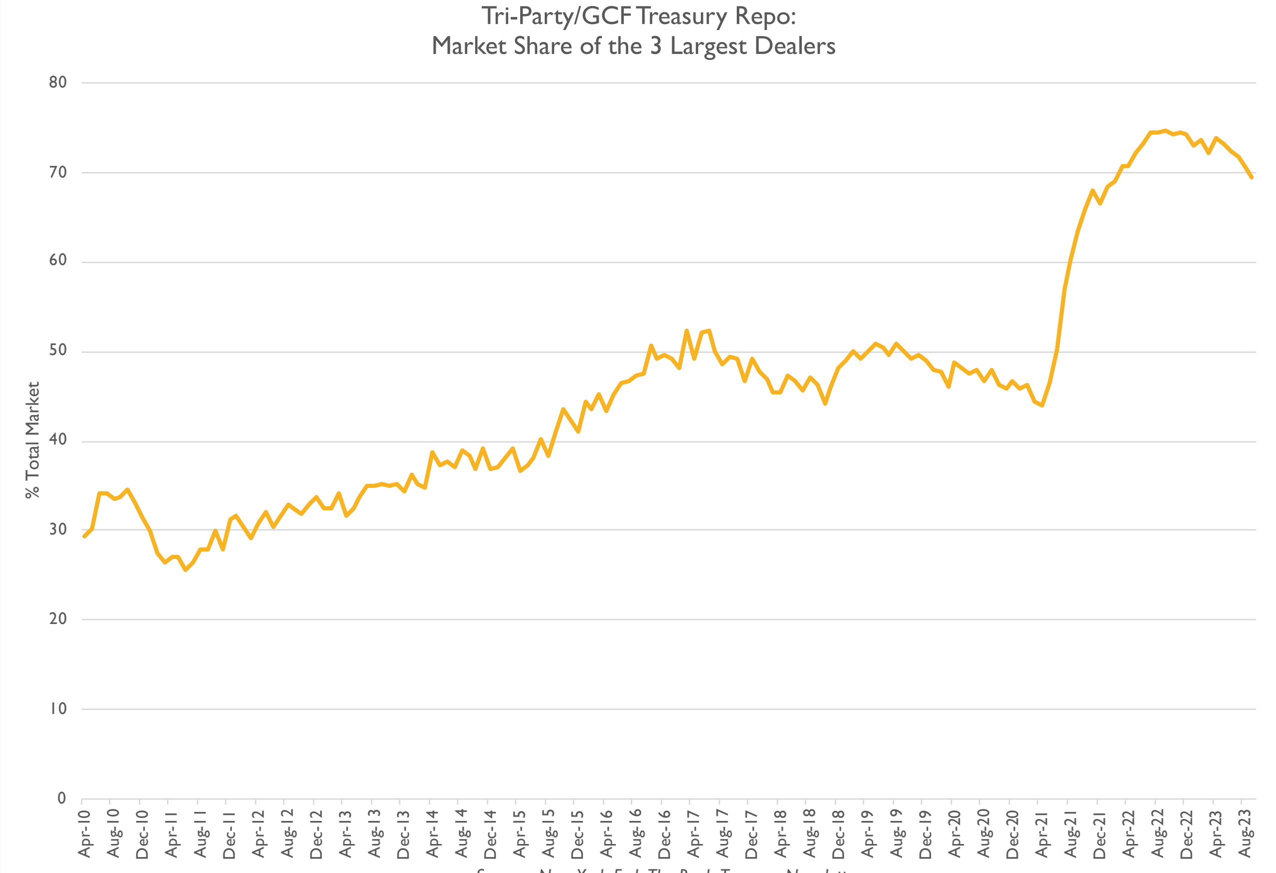
Sponsored Repo And Dealer Concentration

Sponsored repo enables a client of a clearing member to access the tri-party/General Collateral Financing repo market without having to be a clearing member of the Fixed Income Clearing Corporation. It may have fueled an increase in dealer concentration in the repo market since 2021 as money market funds ramped up participation in sponsored repo with cash flooding the financial system during the Fed's previous quantitative easing. But in April 2023, the New York Fed changed the eligibility requirements to participate in its RRP facility, which may explain why the increasing concentration of the 3 largest repo dealers leveled off and may be starting to recede.



Sources: New York Fed, The Bank Treasury Newsletter

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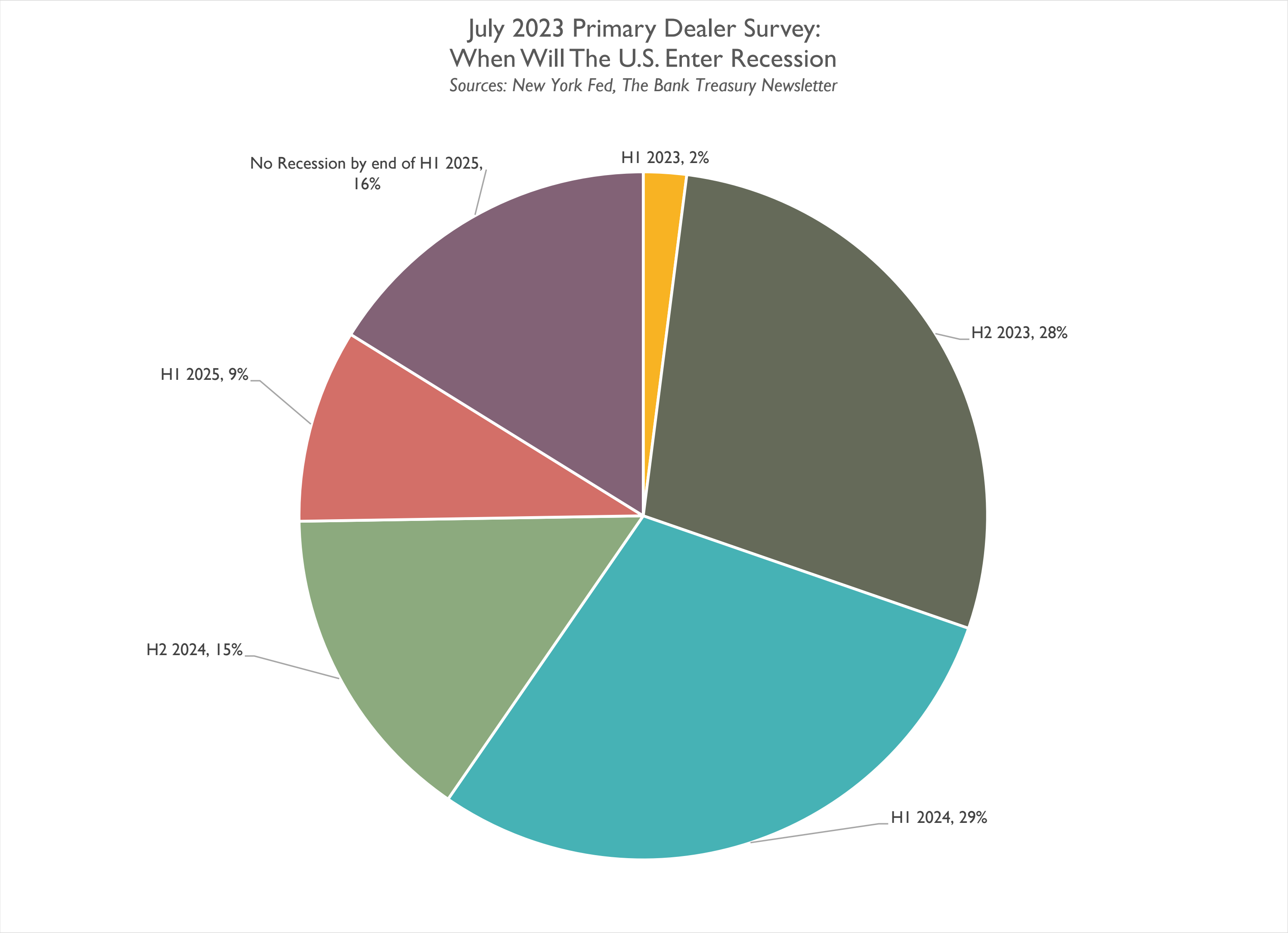
Dealers Expects Recession Around The Corner

Primary dealers expect recession in the next year, but this is nothing new. In the NY Fed's January 2023 survey of primary dealers, 34% said they expected the U.S. to enter recession by H1 2023, 23% expected recession by H2 2023 and 11% expected it by H1 2024.



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