The Bank Treasury Newsletter

The U.S. Treasury is almost finished rebuilding its Treasury General Account (TGA), the checking account that it maintains at the Federal Reserve, following the resolution of the debt ceiling last month. On the Fed's balance sheet, the TGA rebuild was balanced by a decrease in the Reverse Repo Facility (RRP), a facility through which the Fed trades Treasury collateral with money market fund counterparties for their overnight cash. The RRP has a significant influence over the Secured Overnight Financing Rate (SOFR), the rate that replaced LIBOR as a key short-term benchmark rate. The Fed is expected to raise the target Fed Funds rate by 25 basis points this month, which will bump up the RRP rate to 5.30%. For decades, the Fed has usually cut rates after a pause that followed a hiking cycle, and a hike this month following last month's pause would not have been an outcome that most bank treasurers would have expected until very recently.

Deposit outflows and other stresses that developed in the wake of the bank failures last spring have largely abated. Indeed, H.8 data shows that deposits for all commercial banks increased marginally since the resolution of the debt ceiling last month, to $17.4 trillion. Bank reserve deposits at the Fed also increased by a fraction, to $3.2 trillion. These increases are despite the Federal Open Market Committee (FOMC)'s ongoing Quantitative Tightening (QT) policy to shrink its System Open Market Account (SOMA) portfolio. The Fed offset some of the drain on deposits from QT with its Bank Term Funding Program (BTFP) that totaled over $100 billion. See this month's chart deck for more analysis of the changes in the Fed's balance sheet accounts.

Bank treasurers remain wary of extending duration in their bond portfolios and with the rate paid by the Fed for overnight reserve deposits set to increase to 5.4% this month, that investment strategy looks no better. The inversion of the front-end of the Treasury yield curve is now in its eighth month, as the negative spread between the 3-month and the 5-year Treasury ranges from 120 basis points (bp) to 150 bps. The last time the front end of the yield curve was inverted for a longer period was in the year 2000, the year of the dot.com boom and 9/11. A steeply inverted yield curve is a fundamental threat to margins and bank profitability. Banks are facing a competitive loan market where they find themselves often outbid by their nonbank competitors who are increasingly gaining on them because of their unregulated advantage, not weighed down by bank capital requirements that are set to become only stricter and more burdensome.

In the wake of the failure of Silicon Valley Bank (SVB), Signature Bank, New York, (SBNY), and First Republic Bank (FRB), bank supervisors are preparing to tighten capital regulations on banks with total assets exceeding $100 billion and may publish a notice of proposed rulemaking (NPR) before the end of this month unveiling their plans for the so-called Basel 3 Endgame. This refers to a collection of unfinished rules originally conceived after the Global Financial Crisis (GFC) that the U.S. has not implemented yet, including additional capital to cover trading risk, operational risk, and interest rate risk, the elimination of the advanced approach in favor of a standardized model, the expansion of the scope for Total Loss Absorption Capacity (TLAC), possibly also the inclusion of Accumulated Other Comprehensive Income (AOCI) in capital, and a cap on the use of held-to-maturity (HTM).

The severely adverse scenario for this year's Comprehensive Capital Analysis and Review (CCAR), which all 23 participating banks passed, featured a 10% unemployment rate and over $600 billion in credit losses, twice the size of the losses sustained during the GFC by the entire banking industry. But it also had the Fed cutting interest rates to the zero lower bound, a move which would immediately wipe away the banking industry's negative AOCI worries. When tax adjusted, AOCI equaled 18% of Tier 1 capital, according to FDIC data for all commercial banks at the end of Q1 2023.

BANK TREASURERS AND THE KOBAYASHI MARU

Dear Bank Treasury Subscribers,

The Kobayashi Maru (KM) is a no-win simulation famously featured in the opening scene of the 1982 movie classic, Star Trek: The Wrath of Khan. You are in the future and the captain of the starship Enterprise. Suddenly, you receive a distress call from a civilian cargo ship that has gone adrift in the Neutral Zone. If you go in to save the ship, the Klingons will never let you out alive and you will fail the test. But if you ignore the call and do nothing, you will also fail the test.

Mr. Spock, Captain Kirk's trusted first officer, designed the test when he was an instructor at Star Fleet academy. The KM tested a candidate's character, performance under extreme stress, and capacity to make impossible decisions in the most severely of adverse scenarios. The KM was so hard, so impossible to pass, that no cadet had ever passed it. But then Kirk did the impossible.

In many respects, the last three years in the bank treasury world seem like a KM simulation. However, no one should ever mistake the Fed's annual stress test, part of a program that is officially called the CCAR, for the KM. CCAR includes a severely adverse scenario that is pretty adverse. But CCAR is not the KM. CCAR is about the approval of a bank's capital plan. Failure is not an option.

Perhaps CCAR should include a section to test bank treasurers to see how they make the best out of an impossible situation. Bank treasurers do seem to be doing the impossible, their best to find ways to optimize net interest income (NII) and protect net interest margins (NIM). And they are doing so while navigating turbulent interest rate markets saddled with balance sheet liquidity degraded by negative AOCI. The AOCI is so negative that for most bank treasurers their only course is to let their underwater and low-yielding assets bleed off through amortization and maturation.

So, a KM for bank treasurers should not be much of a stretch for them. Of course, sitting on a big capital cushion matters to the outcome. But there is no ignoring the fact that it is precisely in such instances when effective bank treasury leadership and who sits on that cushion matters, as well.

Whether the subject is asset-liability management, funds transfer and deposit pricing, bond portfolio selection, or cash management, whether the decision is to draw on Federal Home Loan Bank (FHLB) advances or fund with brokered or reciprocal deposits, whether the question is to fund today or to take advantage of an inverted yield curve and fund forward tomorrow, a fully-staffed bank treasury team makes that call. And who gets the call when a contingency funding plan needs to be developed?

The bank treasury department!

Yes, treasury is a cost center and in times like these when the chief financial officer (CFO) is looking for cost saves, it might be a tempting place to execute a reduction in force. But time and again, a dedicated, fully-staffed, experienced (and we should hope well-paid) bank treasury team proves its worth to shareholders. As the CFO of a large regional bank headquartered in the northeast told analysts this month referring to decisions regarding his bank's funding decision,

"…it's really up to our treasury team to figure out what's best to do for our company."

Borrowing from real life, the treasurer's KM simulation could could include rapid rate hikes by the Fed and wild swings in the yield curve, from steeply sloped to deeply inverted all in six months. Just to make it more realistic, interesting, and naturally more complicated, it could incorporate random stresses, from the geopolitical to the political, from climate change to currency digitalization, from runaway inflation to sudden bank failures all in the same period of time. Chaos is the ultimate mission impossible, and bank treasurers are....well, not exactly Ethan Hunt, but they are sort of close. As Martin Gruenberg, chairman of the FDIC, said recently,

> *"The banking industry has proven to be quite resilient during this period of stress. Net income still remains high in relation to historical measures, asset quality metrics remain favorable, and the industry remains well capitalized. However, the industry continues to face significant downside risks from the effects of inflation, rising market interest rates, slowing economic growth, and geopolitical uncertainty."*

The FDIC, which technically is not in charge of CCAR, could use the KM to test the mettle of prospective bank CEOs. In the simulation, the subject-candidate for the job gets to be Greg Becker of SVB or Scott Shay of SBNY in the last week before their banks failed. According to FDIC estimates, the bailout for depositors at SVB, SBNY, and FRB will cost more than $30 billion. So all that a candidate would need to do to pass would be to save the FDIC's Deposit Insurance Fund (DIF) some money. Fail, but fail more efficiently will be the test.

Because with a DIF balance that stands at about $100 billion, the FDIC has to cover $10 trillion of insured deposits, nevermind the other $7 trillion of uninsured deposits it sort of implied it will cover, too by guaranteeing the uninsured deposits at SVB and SBNY. Shareholders will foot special assessments to replenish the balance of the DIF, but whether that will be enough or not, ultimately the buck stops with the taxpayers.

And it better be enough, as far as taxpayers are concerned. Which is why failure is not an option with CCAR, and CCAR is not the KM. It is worth remembering how Captain Kirk passed the KM. He did it by hacking the computer, programming a solution into the test. Like CCAR, he designed it to pass. Technically one could call this cheating, but he was commended for his ingenuity, graduated to captain of the Enterprise, and the rest is (or in the future will be history).

CCAR is designed to be passed, and there is a simple hack; hold more capital. If it gets harder, passing it still comes down to the size of a bank's capital cushion. The more capital a bank holds, the more its chances to pass CCAR. But banks need their shareholders to be understanding when it comes to capital, to tolerate lower returns for holding more capital, returns that often are just barely above their cost of capital to begin with. Which is why bank treasurers know how little to count on their shareholders to be understanding. Lower returns are a tough sell in the boardroom when they are already too low.

But the lesson that bank supervisors learned from the failure of SVB, SBNY, and FRB is that equity is good and more is always better. Shareholder tolerance for low returns is not infinite, but it is easy to see why bank supervisors want it to be that way. Capital, Michael Barr, the Fed's Vice-Chair of Bank Supervision, reasoned in a speech this month,

> *"…is what allows the bank to take a loss and keep on operating. The beauty of capital is that it doesn't care about the source of the loss. Whatever the vulnerability or the shock, capital is able to help absorb the resulting loss and, if sufficient, allow the bank to keep serving its critical role in the economy. Higher levels of capital also provide incentives to a bank's managers and shareholders to prudently manage the bank's risk, since they bear more of the risk of the bank's activities."*

These are the marginal benefits. But there are also marginal costs. And there are limits because there is no infinite supply of equity in search of utility returns. As his predecessor, Randy Quarles wrote in an editorial in the Wall Street Journal in 2016,

> *"In the real world of capital markets, however, there are not enough natural investors in bank equity seeking utility-like returns."*

Responding to his successor's speech, speaking at a SIFMA roudtable this month, Randy Quarles had not changed his views, and criticised the conclusion that more is better when it comes to equity. In fact, having a safer banking system means that big banks have to be able to fail,

> *"I think that we are in danger of forgetting…the objective of the post-crisis capital reforms at the highest level. It was, you needed to have a system in which any bank could fail. It was not to have a system in which no bank could or would fail. And…in the implementation of capital reforms, and particularly the…Basel Endgame and the Holistic Capital Review, I think we've lost sight of that fact. We seem to be seeking to create a system in which no bank can fail. And that will almost inevitably be an inefficient system…It will restrict the ability of the…banking system to provide, to fulfill its role in…the financial system and restrict the ability of the financial system to provide support to the real economy. It's a mistake."*

But that assumes you can accurately calibrate capital for all participants to prevent the contagion and spillover that could be caused by one bank's failure, and as Vice-Chair Michael Barr went on to say when he spoke this month,

> *"Our dynamic financial system is complex and constantly evolving. Regulators and bank managers are limited in our ability to comprehensively identify risks and to measure them. We cannot fully appreciate how a specific vulnerability can interact with other vulnerabilities to amplify and propagate risk in the face of a shock, or multiple shocks. It is extremely difficult to identify shocks in advance. And we also cannot fully predict how firms and markets adapt to changes in the environment or to the behavior of regulators or other participants."*

Calibration is difficult, thus the margin for error must be big, bigger, and even bigger. The answer is always more. Simply put, banks cannot fail CCAR, and if they do, shareholders will not be the only ones who will be disappointed. Because if bank managers do not like to meet with angry shareholders, just wait till they meet with the taxpaying public who has to foot the bill.

Because the taxpaying public has no tolerance for failure, forget disappointing returns. Its popularly elected representatives in Washington DC demand answers when they do. Someone needs to be held accountable and bank supervisors and politicians, mindful to never let a good bank crisis go to waste, have their torches and their pitchforks out, demanding answers and photo-ops. Grilling the former CEO of SVB during a Senate hearing last May, Senator Elizabeth Warren went for his jugular, or rather, his bonus check,

> *"Mr. Becker, the collapse of your bank cost the FDIC fund about $20 billion. Money that someone is going to have to make up: big banks, community banks, depositors, consumers, somebody. So, I want to know about basic accountability. How much of the $40 million that you earned from loading up SVB bank with risk are you planning to return to the FDIC?"*

Plus the public really cannot tolerate the threat of financial Armegeddon when a large bank fails. That is the problem. Large banks are too big for the FDIC to cover when they fail. Either the FDIC's DIF has to be a lot bigger or somehow the largest banks need to self-insure the way large employers self-insure to provide health insurance to their employees. If not for the Fed's emergency thinking on March 12th to launch the BTFP and the FDIC's concurrent announcement backing all deposits of SVB and SBNY after they failed, doomsday could have really become a reality for a financial system that for all of its strength still requires regulatory intervention to survive a sudden liquidity crisis that crops up out of nowhere. Considering how close we came, never again is an understandable sentiment for a public policy towards commercial banking and tax-payer insured deposits in a world where epic, systemic disaster lurks around every turn.

So higher capital requirements are on the way, ones that could lead banks with total assets over $100 billion to increase capital by as much as 20%. These capital requirements will come with marginal costs, such as the money banks will spend developing elaborate models to validate holding more capital. And the taxpaying public will ultimately absorb the marginal costs for holding this increase in capital, when banks leave businesses to the unregulated, shadow banks. As the CFO of one of the global banks said,

> *"To the extent that we have pricing power and the higher capital requirements mean that we're not generating the right returns for shareholders, we will try to reprice, and…if the repricing is not successful, then in some cases, we will have to remix. And that means getting out of certain products and services…that probably means that those products and services leave the regulated perimeter and go elsewhere. And that's fine…but in the past. when risky activities leave the regulated perimeter negative consequences follow… And it might in fact mean…less credit available for homeowners and more regulatory risk as the activity moves outside the perimeter."*

His concerns were echoed by the president, chairman, and CEO of another global bank, who complained to analysts about the unlevel competitive landscape and how higher capital requirements could tilt the field even further against the industry in favor of nonbanks and foreign banks,

> *"I think from a global competitive standpoint, we've got to be careful here because…the rules…tend to be more favorable to those outside our country. We've got to be careful to maintain the competitive parity…They've got to think through the downside of some of these rules and that they could push stuff outside the industry to nonbanks. Half the asset classes across the board are in nonbanks, including mortgage lending…half of it goes through nonbanks."*

But as far as regulators are concerned, if higher capital requirements cause banks to exit certain businesses and cede them to non-bank competitors, then as Vice-Chair Barr acknowledged later in his speech, that is a concern but so be it,

> *"While this increase in requirements could lead to some changes in bank activities, the benefits of making the financial system more resilient to stresses that could otherwise impair growth are greater. That is not to ignore concerns that changes in capital requirements may cause firms to change their behavior and the way that financial services are provided to our economy."*

The 23 banks that participated in the 2023 CCAR passed without exception. To do so, they had $1.6 trillion in equity capital going in to the test. According to the results of their own calculations and also confirmed using the Fed's own calculations and models, they could lose $600 billion over a two-year term, equivalent to twice the cumulative net loan charge-offs the industry sustained during the Global Financial Crisis (GFC), still have enough capital to support normal demand for credit, meet all capital requirements, and still pay their shareholders dividends and share buybacks. In other words, they have a lot of capital, and right or wrong, if bank supervisors have their way, soon they will have more.

Next year's test may be even harder than this year's, but generally CCAR became a little easier and a little less fraught to pass after the Fed eliminated the qualitative part of the test in 2019. This was the part that measured how well a bank plans for and measures its risk. To pass the CCAR before 2019, banks not only had hold a lot of equity capital, but they also had to prove that they knew how much they actually needed and that their methodology was reliable. Before 2019, some banks "failed" CCAR over the qualitative section and had to revise and resubmit their capital plans for approval. Eliminating the qualitative CCAR was done in the name of regulatory relief and calibration.

Now, with its "other hand," the Fed did heap additional capital requirements on banks, including the Stress Capital Buffer (SCB) which is tied to the annual CCAR results. Bank supervisors expect to release a NPR very soon, as early as by the end of this month, unveiling their version of the so-called Basel 3 Endgame that, as officials have described in recent speeches, could be even stricter than the one adopted by the Bank for International Settlements.

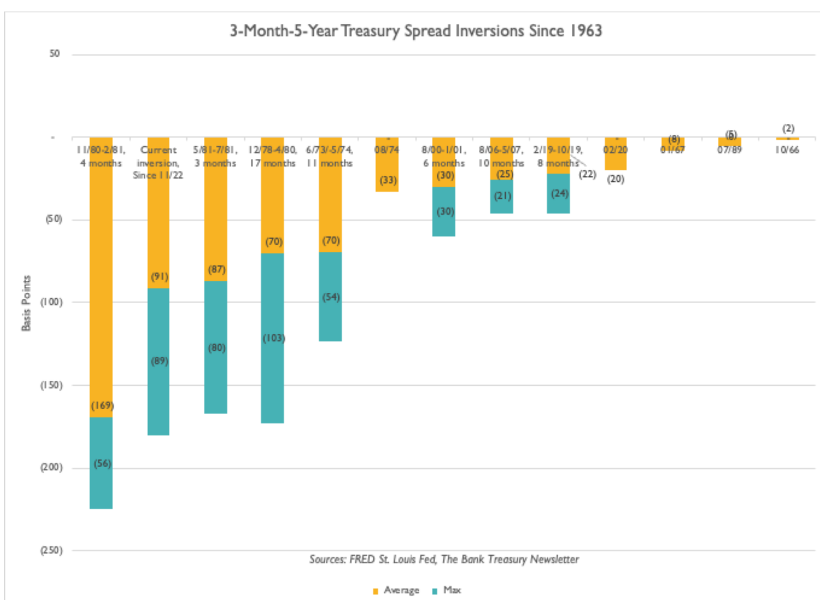
The NPR may also expand the scope for rules such as TLAC and tighten capital rules for trading and operational risk. Adding insult to injury, after forcing the largest banks to develop advanced approaches for calculating risk capital, the supervisors will likely propose to eliminate the advanced approach in favor of a standardized model. The NPR could even require capital to cover interest rate risk in the banking book.

Even with a lot of capital, and even without the qualitative section, CCAR is a tough test to pass, but there was a major bright spot with this year's test. This year's severely adverse scenario assumed that overnight the CPI inflation rate falls to 1.3% and that the Fed snaps around and cuts interest rates back to the zero lower-bound. The scenario has the yields on 3-month, 5-year, and 10-year Treasurys, as of publication, at 5.4%, 4.2%, and 3.9%, respectively, falling to 0.1%, 0.8%, and 0.8%, respectively.

Thus in the scenario, the world is doomed, but negative AOCI worries are wiped away overnight. Bank treasurers must have chuckled when they saw that in the CCAR scenarios published last February. In fact, the scenario's overnight elimination of negative AOCI offset much of the hit from the credit losses they were projected to incur, and the 23 banks ended up doing better in terms of the net capital hit they had to absorb than compared to how they did in last year's CCAR.

And the yield curve goes back to positively sloped in this scenario. Bank treasurers would love a little relief from an inverted yield curve wbich is fundamentally bad for a banking model based on a positively sloped curve. The yield curve is so inverted today that interest rate historians would need to go back 40 years to find a similar time when bank treasurers were under this much rate stress. The spread between the 3-month and the 5-year Treasury has been deeply inverted for eight months (Figure 1), one of the longest inversion periods in 60 years. The only time when inversions lasted longer was in the 1970s and 1980s. Moreover, the present inversion is the second most negative in 60 years.

Figure 1: 3-Month-5-Year Treasury Spread Inversions Since 1963



Of course, how bank treasurers make their marginal cost of funding that exceeds 5% work to fund loans generally tied to the intermediate part of the yield curve yielding 120-150 basis points less is the magic of bank treasury. For larger banks with sizeable fee businesses, the inversion of the yield curve is not a hassle. According to the chairman, president, and CEO of a large regional bank headquartered on the east coast, an inverted yield curve does not matter to lending decisions. The bank can afford it. His balance sheet is prepared for rates to go in any direction, higher or lower, he said,

> *"I think at the 10,000-foot level, our appetite to lend and support our clients isn't affected by short-term funding costs…With respect to interest rates, we are as neutral as we can otherwise be."*

A no-win situation is one where any move is the wrong move and thus, in such situations, the only move, the best move is to stand still. When you do not have a move to make, the best thing, if you can afford it, is to not move. That is not always an option. Fortunately, with short-term rates over 5% well above the rest of the intermediate and longer end of the yield curve, standing still pays very well. Investors do not have to reach for yield, as the president of a large asset management company told analysts this month,

> *" You can actually earn attractive yields without taking much duration or credit risk…Clients shifted towards illiquid investments over the last decade to get those returns. But while there is still demand for the private markets to diversify…investors can get most of that yield…through bonds."*

The CFO of a regional bank based in the northwest has his cash sitting at the Fed and earning interest. Defending his decision to leave it there rather than extend duration he said,

> *"Cash is sitting at the Federal Reserve, earning the 5%, 5.25%. We just think it's prudent to hold that at this point just based off the environment till the outlook clears before we make some moves."*

The above-quoted chairman, president, and CEO of a large regional bank headquartered on the east coast was not ready to extend the duration of his bond portfolio. Disagreeing with the forward curve and discounting the possibility of rate cuts later this year, he argued that,

> *"Adding in this environment would be choosing to get long. Choosing to get long would basically be saying that we think the forward curve is correct. And I'm not sure we agree with that yet…I think the big unknown for us and everybody is if and when the Fed pauses and then cuts rates, what actually happens to the shape of the yield curve in term rates. Expectations are you'd see a massive flattening. So I'm not sure at the moment that there's value to be had in extending duration."*

His caution is understandandable. Bank treasurers need to know when to extend them and when to hold them, to paraphrase the late Kenny Rodgers in the 1980 classic, "The Gambler," because timing is everything. When your timing is off, you can get negative AOCI, bonds so underwater they cannot be practically sold, and balance sheets at the risk of technical insolvency if they are. Yes, mark-to-market accounting is just accounting, now in its 29th year since the Financial Accounting Standards Board (FASB) published Statement of Financial Accounting Standard No. 115, "Accounting for the Investment Portfolio," and gave us lop-sided accounting rules, and balance sheet items called AOCI, Available-for-Sale, and HTM. Yes, it is just accounting, and no one cares. The fair value of fixed income bonds paying 2% when the market rate is 5% does not matter if you can hold the bonds until they amortize or mature at par.

But accounting is not important until it is. There is no time like now to get out, to sell, at least to SVB, SBNY, and FRB's uninsured counterparties.

Accounting and underwater investment portfolios could be a key reason why a wave of bank consolidation could take a while to build. Obviously a bank whose liabilities exceed its assets can be a difficult sell in the boardroom, accounting or no accounting, unless the FDIC is offering a deal. And this is even without considering all of the other chaos going on in the markets. But, as the CFO of a large regional bank based on the east coast explained, there are also asset quality issues for a buyer to consider and a lot of other unknowns beyond just fair value.

> *"I think for the industry broadly, it's fair value accounting… most banks that would get together would need a substantial capital raise. And that's going to stop people from doing things. I think you've heard quite loudly coming out of D.C. recognition that there's going to need to be consolidation in the industry to create competition against some of the giant banks…I think we're in an environment in a credit environment where that can be dangerous because I think there's a lot of bad balance sheets out there, heavy real estate concentration and other things that would be a red flag."*

Deposit franchises may not even be as attractive as they once were, the stickiness of deposit funding, especially the uninsured, not looking as sticky in the eyes of investors and bank supervisors after SVB, SBNY, and FRB, as they once were. The digitalization of bank deposits will take time, as the slow take up of the new FedNow service demonstrates, but when the transformation is complete, every bank deposit no matter how small and no matter how stable will be a little bit less stable, a little bit less loyal and core. At least that is the way they will be modeled. And bank treasurers need to be prepared. Deposit mixes are changing and deposit duration is shortening up according to a CFO from a regional bank in the southeast,

> *"What we've seen is that our -- as rates have risen, our asset durations have expanded, and we think our liability durations have shortened. Now what you're seeing is a mix change from the product that you would usually assume as your longest duration product of DDA towards CDs, which have a stated duration to them, right? So it's -- you're seeing some mathematical mix change affecting the duration. But then you're also seeing with price competition, customers move around."*

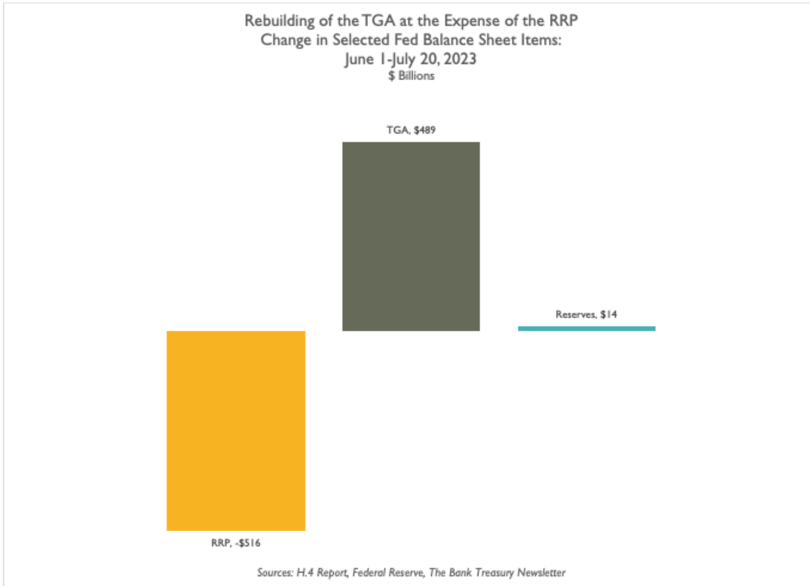
Also, buyers follow an old rule in the financial markets called do not fight the Fed. This month might be the last rate hike of the cycle or it might not be. Bank treasurers are as uncertain as the rest of the market and as are probably voting members of the Fed about that and until they are less uncertain, standing still is their best option. Even then if rate hikes end, tightening may effectively continue if the Fed pauses rate hikes but sticks with its $35 billion Agency MBS and $60 billion Treasury QT monthly caps program.

Because it is not rates but QT that has been driving deposit outflows over the last year and it is QT that has gotten bank treasurers most worried, when they are not thinking about the Treasury refunding that is coming, that the Treasury projects will increase Treasurys outstanding by $733 billion just in Q3 2023, with more issuance expected for Q4 2023. Even sitting with $5.2 trillion more deposits than bank loans, these are all reasons for them to sit tight on cash and leave it at the Fed, rather than extend duration or take on more risk. As the CFO of a regional bank based in the northwest told analysts, he saw nothing to change his stance and besides, with today's short-term rates, it did not cost much to sit tight for now and do nothing,

> *"Given there's still QT deposit pressure out there, we feel it's prudent to hold on to that higher level in cash. As we see that change, then that target level of on-balance sheet cash will change, but it hasn't happened as of this point…When you look at the net cost of that cash that is parked at the Fed, it's not material, we think it's just prudent to hold on to extra liquidity for the time being."*

But on the bright side, the post-Debt Ceiling rebuilding of the Treasury's TGA so far appears to have been absorbed on the Fed's balance sheet through a reduction in the RRP (Figure 2) instead of reserves. In fact, bank reserve deposits at the Fed were up marginally since June 1st. The other alternative instead of the RRP would have been to balance the increase in the TGA with a decrease in bank reserves, which bank treasurers feared could have put additional downward pressure on deposit balances. How much lower the Fed will reduce the RRP and spare reserves remains an open question as the Treasury proceeds with its refunding plans for the rest of the year. For now, bank managers saw deposit outflows as slowing or that they had stabilized, and recent H.8 data shows that since the end of April, bank deposit balances were higher (See this month's chart deck for more information on bank deposits and the Fed's balance sheet).

Figure 2: Rebuilding of the TGA at the Expense of the RRP



There are marginal benefits to a smaller RRP. Through the RRP, the Fed accepts deposits from the money market funds that would have otherwise gone into the general repo market. Therefore, the larger the balance of the Fed's RRP, the less cash is available for the rest of repo market. Therefore, a decrease in the RRP balance should have a positive effect on the broader repo market, where the current SOFR has averaged a basis point above the Fed's RRP rate since the yield curve first inverted late last year (See the Chart Deck for more details).

A positive spread between SOFR and RRP implies that short term cash left over from the Fed's RRP is short of the demand for cash for dealer financing. This was intentional by the Fed in its quest to tighten the supply of money and tame inflation. But the Treasury's refunding plans for H2 2023 are on top of regularly scheduled monthly QT, so ultimately $1.7 trillion of RRP and $3.2 trillion of reserves need to absorb refunding and QT and still somehow maintain ample reserves in the banking system and a functioning repo market. How to do so without undermining market stability is an uncomfortable unknown for bank treasurers to contemplate. As in KM, another no-win situation. According to the CFO of one of the global banks, a lower RRP balance will be a net positive for short-term markets reliant on a better balance between cash and collateral providers.

"We got through the debt ceiling, and the TGA build has come into effect, and you've seen a lot of Bill issuance, a big question in the market about whether that was going to come out of reserves or come out of RRP. And so far, with most of the TGA build…most of it, not as some people feared, has come out of the RRP. I think that's a relatively good sign and highlights how the system works better when you've got ample supply of short-dated collateral on the front end of the yield curve. So that whole RRP, TGA, bank reserve dynamic is going to continue to be significant, but it is good to see RRP coming down a little bit."

Competition is always going to be a factor determining deposit balances at individual banks. Rallying his troops in the frontline branches, the CFO of a regional bank in New England, a region where high loan-to-deposit ratios are common, told analysts this month that the effort to gain and retain deposits is mission critical,

> *"It is a challenge because loans are growing faster than deposits. So, we need to fund that…partially with broker deposits, partially with home loan advances but also by continuing to fight tooth and nail for consumer and commercial deposits…Our frontline bankers that are generating deposits as well as loans."*

There may be $5 trillion more deposits than loans in the banking system, but some banks have enough deposits and some do not. And competition is fierce all over, more than had been expected, as the president and CEO of a regional bank in the southeast conceded,

> *"The environment we're in and the competitors that we have who are loaned up way too close to 100%. They -- we want liquidity. They have to have liquidity and they're pricing accordingly, and that's driving some of our cost up a little faster than we would like to see them. So, our thought of normalization may be a little bit further, maybe over past year-end and into '24 versus the back half of this year like we had hoped a quarter or so ago."*

And while these pressures are serious, bank treasurers take a lot of solace in the fact that at a fundamental level, the public will always keep a primary checking account at a bank, just like the U.S. Treasury maintains one at the Fed. And even if the public suddenly sees that it can get a very attractive rate at a money fund, it will still keep some balance of its savings in a bank. In fact, as bank managers reminded equity analysts this month, the balance of the public's checking accounts paying them nothing at all and maybe even charging them fees for the privilege is pretty stable or stabilizing in recent months. Changes seen in the past year in the mix from noninterest to interest-bearing, the deposit outflows to the money funds, all that stopped, or slowing down.

Not to say bank treasurers are relaxing, but things are getting better. As the CFO from a large bank based in the northeast told analysts,

> *"We're starting to see a deceleration in deposit migration -- in negative deposit migration."*

There is a reason for that, why the outflows could be slowing. Ultimately, the public has to keep a deposit balance to participate in the payment system and the broader financial system. This is true for the little guy as much as for the largest institutional accounts. As the chairman, CEO, and president of a global bank said,

> *"We think about, what do they have cash flows for? They have cash to transact, and they have cash that's in excess of that…The transactional cash is all with us. That transactional cash far exceeds, for us, our loan balances. So we have excess transactional cash. And a lot of it is low-interest checking, no-interest checking. Even if it's the money markets, it's that sort of cushion that consumers and wealthy people -- wealthy consumers and average consumers maintain to pay their bills and unexpected expenses…The average balance in our checking accounts has gone from a high of $11,000 at the peak to $10,000."*

And as the CFO of a global bank with custodial accounts explained,

> *"I think what's happening in this part of the cycle is as deposits or I'll say, as cash for our clients is more valuable, right? They are selectively thinking about how much cash do I absolutely have to keep in the -- in their custodial accounts…They're trying to see, hey, can I edge it down…And the reason why it will level off over time is that they need a certain amount of deposits that they don't overdraw…And it's a part of…what makes custodial deposits so sticky, right, because they need to*

be there for the very significant daily, hourly and minute-by-minute transactional flows that we are processing on their behalf so that they aren't overdrawn."

The CFO and principal accounting officer of a regional bank in the southeast declared the fire drill on balance sheet liquidity over and done.

"We're more or less back to managing the balance sheet in a normal fashion. So the level of liquidity we kept on the balance sheet at June 30, maybe a bit higher than what we would normally do. But not much more."

Maybe everything works out. Perhaps like Captain Kirk, bank treasurers really can defeat the do the impossible and save their NIMs and NIIs, can meet uncertain liquidity needs, and stand strong through volatile markets. There is a light at the end of the tunnel and we are in the late innings, the CFO of a large regional bank headquartered in the Midwest told analysts,

"If I had to kind of say, what inning are we in, I think we're in the late innings simply because of where the Fed is from a monetary policy standpoint. So while there may continue to be a little bit of downward pressure, we don't see it as being significant from here."

If we are in the late innings and economic numbers continue to come in strong, even predictions for a soft landing might be too pessimistic. That seems to be the latest thinking by the International Monetary Fund. Despite the odds, the Fed appears to be passing a KM of its own making, taming inflation and keeping the economy growing at the same time. But, the chairman and CEO of a global bank remained cautious, refusing to move when the future is unknown.

"We know we don't know the outcome. We're trying to be really clear here. The consumer is in good shape. They're spending down their excess cash. That's all tailwinds. Even if we go to recession, they're going with rather good condition, low borrowings and good house price value still. But the headwinds are substantial and somewhat unprecedented. This war in Ukraine, oil, gas, unprecedented fiscal needs of government', QT, all which we've never experienced before. We don't know if those things could put us in a soft landing, a mild recession or a hard recession. And obviously, we still hope for the best."

The president and CEO of a regional bank in the southeast was more upbeat about the future. Growth is slowing, but it is still growing.

"When we talk to our clients, particularly the larger clients, 4, 5 months ago or so, there was a lot more -- when I say concern…very mindful of the risk that if the Fed's increase in rates was so steep and so long and kept going, then we could see that proverbial hard landing. We really don't hear that kind of concern from our clients anymore. So they may be tightening down a bit to grow capital and to preserve liquidity and to get as much return as they can for but it's not fear of an economic downturn. It's just…slower."

Captain Kirk might have made it out of the Neutral Zone and escaped the Klingons and bank treasurers might be seeing a light at the end of the tunnel with Fed rate hikes. But there a lot of unknowns. You can only hack your way out of so much. Which is why they are playing it cautious with their balance sheets. In the current market there is no reason for them to do otherwise. Focus on short term returns, strong liquidity, and a fortress balance sheet will not produce great returns, but in the present circumstances, those returns just might be good enough to do the impossible.

The Bank Treasury Newsletter is an independent publication which welcomes comments, suggestions, and constructive criticisms from our readers in lieu of payment. Please refer this letter to members of your staff or your peers who would benefit from receiving it directly or have them contact me directly to be added to the distribution list.

Ethan M. Heisler, CFA
Editor-in-Chief
Email: Ethan.heisler@thebanktreasurynewsletter.com
Cell: 516.359.0975

THE BANK TREASURY NEWSLETTER