The Bank Treasury Newsletter

The Fed announced a consent order on June 1st against Silvergate Bank, to facilitate its voluntary self-liquidation. The reverberations of what turned out in retrospect to have been a short-lived, liquidity crisis thanks to the quick intervention by the Fed and the FDIC, continues to be felt by banks across the size spectrum of institutions. In just two months since the failure of Silicon Valley Bank (SVB) and Signature Bank, New York (SBNY) in March, and then First Republic Bank (FRB) last month, the banking system lost over $300 billion in total deposits, the balance falling to $17.2 trillion as of mid-June. From the Federal Open Market Committee's (FOMC) first rate hike in March 2022 until December 2022, deposits were only down $0.4 trillion. Call report data suggests that most of the outflow was from uninsured deposits. From year-end 2022 though the end of March 2023, uninsured deposits fell by $0.4 trillion, the bulk of which came from banks with total assets between $10 billion and $250 billion.

Money market funds were a prime destination for uninsured depositors, which from the end of February 2023 to the end of April 2023 increased by $400 billion, to $5.8 trillion. When the Fed began hiking rates in March 2022, these funds stood at $5.1 trillion, more than half of which today is in Treasury repo, including $2.2 trillion in the Fed's Reverse Repo Facility (RRP). (See this month's chart deck for more details.) Banks and the money market funds are the main cash providers in the repo market, but Quantitative Tightening (QT) and the Treasury's plan to replenish its Treasury General Account (TGA) could threaten the balance in the repo market between cash and collateral providers. While the Fed's new Standing Repo facility (SRP) is designed to support primary dealers in the event of a liquidity crunch, it remains untested. The Treasury repo market is the basis for the new Secured Overnight Financing Rate (SOFR). After June 30th, the old London Interbank Offered Rate (LIBOR), will cease to be quoted. The new FedNow service starting next month will only add to liquidity challenges for the industry.

Bank treasurers report that uninsured depositors were, less pulling cash out of the banking system, than diversifying relationships across more institutions. Use of reciprocal deposits also increased in this regard, from $6 billion to $19 billion in Q1 2023, but most of the increase was attributable to a handful of institutions that had been under assault in the equity market and appear primarily to have been shoring up liquidity buffers. Indeed, many of the same institutions that led the list of banks funding with reciprocal deposits were also at the top of the list of institutions borrowing from the Fed's new Bank Term Funding Program (BTFP). The BTFP grew to $100 billion as of June 7th which partially offset the effect of QT.

In the wake of the failure of SVB, SBNY, and then FRB, bank treasurers generally expect regulations to tighten around liquidity and interest rate risk management. They are also anticipating the outcome of the so-called "Basel 3 Endgame" which they believe will result in a wider scope for capital and liquidity requirements, the elimination of the advanced approach risk-weighting in favor of a standardized approach, and a reconsideration of the treatment of Accumulated Other Comprehensive Income (AOCI) in regulatory capital. Regional banks, potentially as small as $50 billion in total assets, may be required to raise Total Loss Absorption Capacity (TLAC) capital, including debt that can be converted into capital in the event of their failure. Even banks that fall outside the formal scope of the new rules, may fall inside some of them informally in the name of best practice. Fed officials are promising a draft proposal will be published by the summer.

The spread between the 3-month and 5-year Treasurys flattened from a peak inversion of minus-180 basis points in the immediate aftermath of the failure of FRB to minus-130 basis points post this month's Fed announcement but remains an obstacle for bank treasurers trying to price loans competitively and pay fair rates to their key depositors. Bank managers nevertheless report slowing loan growth reflecting lower demand. On the deposit side, the latest FDIC data shows that noninterest bearing deposits equaled 26% of total domestic deposits at the end of Q1 2023, down from 30% at its peak.

BANK TREASURERS STAY INDOORS

Dear Bank Treasury Subscribers,

Fresh air is over-rated, it can cough, cough make you very sick. For sure it is crazy about those Canadian wildfires, but bank treasurers have enough crazy going on in their world that they can be forgiven if they are not much concerned right now with climate change and air quality.

Unless it affects the Fed's rate policy, of course. Honestly, bank treasurers are not the kind of people that get out much for a little sun and fresh air when they are working. Which is always. Especially these days. They are too busy trying to keep up with the information flow that they really do not have time to step outside, even for a smoke.

And there's too much to pay attention to on their computer screens to look away, all those green, yellow, and red points of blinking lights. With the debt ceiling behind them, T-Bill-megeddon now tops their wall of worry, as they brace for more than $1 trillion in Treasury Bill issuance over the remainder of 2023 to replenish the Treasury's checking account balance at the Fed, the TGA. By any comparison with recent history, that's a lot of T-Bills.

And a lot of numbers to keep straight in one's head that needs no distractions or a walk outside.

To appreciate the amount of liquidity that the Treasury could pull out of the short-term money markets over the next six months, consider that after one full year of QT, the Fed reduced its total System Open Market Account (SOMA) portfolio of Treasurys and Agency Mortgage-backed securities (MBS) through run-off by $0.8 trillion, to $7.7 trillion. Leaving aside the shortened time frame for T-Bill issuance compared to QT, by some projections, T-Bill issuance for the next six months could be twice as large as what ran off from SOMA already. And on top of that, unless the Fed pauses QT which is said it was not doing yet, there could be $0.4 trillion or so more of additional SOMA run-off based on the pace it has been going at so far.

Bank treasurers are understandably concerned how this will affect their deposit funding, which presumably the public will hit to pay for the T-Bills that will be issued. Driven down by QT, deposits were being slowly drained until the failure of SVB and SBNY in March 2023. According to the Fed's H.8 report, when the Fed began raising rates in March 2022, deposit balances had peaked at $18.2 trillion. Deposits slipped from there to $18.0 trillion by the time the Fed began QT in June 2022.

From then through last March 2023 deposits equal to $0.5 trillion slipped out the branch doors and out of the banking system. That equates to $50 billion a month of deposit run-off and was driven by the run-off from QT, which averaged $66 billion a month. (For the record, and just as a parenthetical aside, the Fed had planned in May 2022 for up to $95 billion a month in SOMA run-off after September 2022, $60 billion from Treasurys and $35 billion from Agency MBA, but its $1 trillion investment in 1.5% and 2%-coupon MBS extended with the sharp rate hikes and complicated those plans.)

But then came March 2023 and suddenly words like "run" became very sensitive in the bank treasury world. In the wake of the bank failures, through the middle of this month, $0.3 trillion of deposit balances ru--, er…left—more like rushed out the door, bringing the total deposit outflow since March 2022 to $1 trillion. That's a lot of big numbers, but bank treasurers are used to big numbers, and hold on, because there are more numbers!

A trillion dollars of deposit run-off! But even then, the banking system still has a lot of excess deposits, $5.1 trillion more than loans to be exact (see this month's chart deck Slide 11 for more details). Yet, stuffed as they are with excess deposits at still historic levels that weigh on their net interest margins (NIM), facing less attractive alternatives to go with the cash in the absence of loans, the put-it-in-held-to-maturity strategy to protect regulatory capital suddenly not looking as attractive a balance sheet management strategy as it once seemed, bank treasurers are the ultimate packrats and find it hard to let go. We hate deposits, but we love them, anyway. Just like family. But they will show some tough love because they know it is a fool that chases money that wants to leave. But they really hate losing deposits.

But it is only fair to ask the money market funds to do their share in the Treasury's TGA replenishment plans. They picked up a lot of the dollars that flowed out of banks over the past 15 months. Money market fund balances hit a record $5.8 trillion, at the end of April 2023, according to the Office of Financial Research (OFR)'s Money Market Monitor. They stood at $5.1 trillion in March 2022 when the Fed began raising rates, increased by $0.3 trillion after one year, and since the bank failures they grew by another $0.4 trillion.

And where are the money funds going with the deposit money that left the banks? Because money market funds basically make short-term, very liquid investments, there are really two choices for them to invest short-term cash and earn a better return for the depositors than what the bank they left was willing to pay. Either the funds could buy T-Bills, or they could find another bank that would be willing to pay what other banks would not pay for the deposits.

With T-Bill issuance having been constrained since last January, when Treasury Secretary Yellen announced that the Federal debt had reached the ceiling and that she was taking extraordinary measures to continue to pay the nation's bills in full and on time, the Fed's RRP facility, paying 5 basis points over the lower-bound of the Fed funds target range, became a very good deal for the funds looking to make ex-depositors happy. And that's the problem.

The RRP is public enemy numero uno for bank treasurers who want to know why the Fed is facilitating the overnight investment needs of the money market funds and disintermediating them of their "rightful" claim on deposits in favor of their nonbank-competitors. Bank treasurers conveniently forget that the Fed pays them 10 basis points more than it pays the funds for their excess deposits and ignore the vital role the facility plays in helping the Fed to square the circle between maintaining an ample reserve policy and pursuing a hawkish rates policy at the same time. But their complaints are still legitimate. The RRP does help money funds compete for bank deposits. As the CEO and chairman of a regional bank headquartered in the northeast complained,

> *"I think the RRP was never designed to be this big…competing with aggressive rates and sucking deposits out of the banking system. You can rest assured we've made that point on our trips to Washington, that there needs to be a plan and ultimately to bring that down."*

The president and chief operating officer of one of the large global banks agreed, telling analysts this month,

> *"We have…the RRP program, that takes deposits out of the system. That is something that we haven't experimented with much in the past. It's been there for a while. But now with money markets having this ability to -- money go to money markets and then go to RRP is something that, at some point, probably what the Fed would want is the RRP to go down, stabilize reserves and that create that proper balance between the RRP and reserves."*

The Fed needs to cut the rate on the RRP, argued the chairman, president, and CEO of a large regional bank headquartered on the east coast.

> *"The Treasury is going to issue $1 trillion of Bills. And if all else equal, it drives into the money funds. What we're hoping to happen and has been part of the dialogue is that the Fed would change the price somewhat on IOR and on the reverse repo facility rate. You should see the reverse facility shrink as the Bills hit the market. And practically, you end up with not much effect on the banks."*

A few more numbers to consider. Assuming the Fed continues with QT and run-off continues at the same pace through the end of the year, how will the Fed balance out a $0.4 trillion reduction of its SOMA portfolio, which sits on the asset side of its balance sheet? With which liabilities will it balance that reduction and say, a $0.7 trillion increase in the average balance of the TGA, which sits on the liability side of its balance sheet? Bank reserve balances equal $3.3 trillion and the RRP equals $2.2 trillion, and both liabilities will have to shrink between now and the end of the year by about $0.9 trillion. But which one will absorb most of the QT and the increase in the TGA?

But it really does not matter where the money will come from, whether the money funds or the banks, because either way, the Fed is playing with fire. Because the banks and the money market funds are both central to the functioning of the repo market. The money funds have $2.7 trillion invested in Treasury repo, which is roughly half the size of the total repo market. The banks fund the rest. If you have a shortage of funds in that market, watch out. Repo is the heart of the money markets, and the basis for the most important money market rate of them all, the SOFR.

Just a quick word about SOFR. As bank treasurers know, at the end of this month, SOFR will say goodbye for the last time to the old U.S. dollar LIBOR. Starting next month, it will be king LIBOR is dead and long live king SOFR. The two good things bank treasurers liked about LIBOR was first, that it came in different terms, like clothing in different sizes, including overnight, 1-week, 1-month, 2-month, 3-month, 6-month, and 12-month. It also came with a built-in credit component that adjusted to changes in credit conditions. LIBOR was good for pricing loans and deposits. SOFR comes in just one size, overnight and is a risk-free rate. Kind of a no-frills benchmark, the equivalent of the paper bag with those paper handles they give you at the supermarket if it were clothing.

Term structure models and credit add-ons are constructed to make SOFR more like LIBOR and so far, for all the recession worries and considering what markets just went through with SVB, SBNY, and then FRB last month, credit conditions remain stable and nothing like they were during the Global Financial Crisis (GFC). But time will tell whether snuffing out the alternative credit rate benchmarks (who still remembers the Bloomberg Short-Term Bank Yield Index and Ameribor?) was really a good idea when times get rough again. And they probably will when least and in the last place expected, but which in retrospect will seem obvious.

So, a little history and perhaps some parallels. The date was September 16, 2019, and this was the Fed's balance sheet back then. SOMA was $3.6 trillion, bank reserves equaled $1.5 trillion, currency in circulation, which today equals $2.3 trillion, equaled $1.8 trillion, and the TGA equaled $185 billion. The RRP facility did not exist in 2019, launched as it was in 2021, and the SOMA was simply balanced by currency, reserves, and the TGA. (The Fed's balance sheet was and still is a little more complicated than that, but those were the basic numbers.) On September 16th an accident happened in the Treasury repo market that brought them all into play.

It was a beautiful fall day, 11 years after the GFC. Birds were singing outside, and the public was paying its corporate taxes and remitting funds to the Treasury for the settlement of $78 billion in new Treasury issuance, pulling out cash from money market fund accounts and bank deposit accounts in the process. The money market funds in turn pulled out the cash they had in the repo market, and banks drew down on their reserve balances at the Fed. That's the financial system for you. It can do two things that reduce the supply of reserves and the cash in the repo market at the same time, and everything should go fine. And should have gone fine, except that…

Let's continue to set the scene. Bank treasurers recall that at its July 2019 meeting, the FOMC had paused the first QT (October 2017-July 2019) and cut its target range for the Fed funds rate by 25 basis points, to 2.00-2.25%, its first cut of what would turn out to be three 25-basis point cuts made before the onset of Covid. As detailed in a recent report by the OFR,[1] the supply of reserves was noticeably constrained after nearly two years of QT, its effects compounded by an increase in the Federal debt, from $24 trillion in 2016 to $26 trillion in 2019 (adjust for inflation in August 2022 dollars). By September 2019, primary dealers were trying to finance a record level of net trading positions in Treasurys.

Bank regulations were also an issue, in particular the Basel 3 Liquidity Coverage Ratio (LCR) and the Basel 3 Supplementary Leverage Ratio. These regulations increased bank demand for reserves to meet high-quality liquid asset requirements, reduced their willingness to lend them in the repo market, and raised the capital cost for their investment in repo, in what is and what has always been a low risk, but also low return business.

The Treasury repo market is based on a balance between cash and collateral providers, and by September 16, 2019, things were not balanced. You could have seen it in the way that SOFR frequently spiked above the effective Fed Funds rate (EFFR), and by the next day, on September 17th, SOFR blew up, suddenly spiking to 5.25%, a full three points above the EFFR. The Fed came in to save day, buying Treasury Bills and injecting cash into the repo market to calm the financial markets. To encourage banks to increase the supply of reserves in the repo market, it also cut the rate it paid on reserve balances by 5 basis points, setting the rate 10 basis points below the top of the target Fed funds range.

Then came Covid and a return to zero interest rates and Quantitative Easing. Then there were rate hikes and QT, a little business about the debt ceiling, and now we are here. It is always helpful to review how we got here. Talk about what a long, strange trip it has been! Thank you, Grateful Dead!

This history comes to mind as bank treasurers think about the how they plan to navigate financial markets and steer their balance sheets through the regulatory backlash they expect to see following the failure of SVB, SBNY, and FRC. Bank treasurers anticipate that the scope for the LCR could extend to smaller regional banks, and even if they do not expect to be formally in scope for the LCR, they still expect to be informally in scope through the bank examination process. That is when examiners will sit down with bank management and review best practices around liquidity and interest rate risk management, and where there will be a meeting of the minds about how cash is king.

The events of September 2019 come to mind because then like now, the public debt is up, having gone from $26 trillion in 2019 to $31 trillion in 2022. Then, like now, the yield curve was inverted, though by much less than today. Then, like now, the repo market is a little tighter than it has been, a sign of which is that SOFR no longer sets below the RRP rate as it tended to do before November 2022. (This month's chart deck (Slide 6) looks at the SOFR-RRP spread relationship in more detail.) And it comes to mind because then, like now, and as all experienced bank treasurer will tell you, a hawkish Fed is when things break, and some things have already broken.

First it is the failure of SVB, SBNY, and FRB, next it will be something seemingly unconnected but in retrospect another accident waiting to happen. When the Fed is tightening rates, watch out. That is what bank treasurers deep down are worried about and T-Bill-megeddon and more QT only add to their anxiety that another shoe is going to drop. And so,

[1] https://www.financialresearch.gov/working-papers/files/OFRwp-23-04_anatomy-of-the-repo-rate-spikes-in-september-2019.pdf

they are going to sit on more cash. Cash is king, an expensive king to maintain most of the time, but these days, worth every penny.

Is this a good time to bring up FedNow, a new service going live next month that will let any individual or company make an instantaneous payment to any other individual or corporation. FedNow will basically replace Zelle or Venmo. A bank depositor will have access to the service day or night, weekdays, weekends, and even holidays, through rain, sleet, and forest fires. The overnight bank run on SVB that was enabled through exceptions would be the rule starting next month under FedNow. No bank would be safe from an SVB or SBNY-style overnight run. Thus, FedNow is going to add to the increased demand by banks for reserves. Banks of all sizes are going to need to rethink their liquidity management thinking. As the president and CEO of a large global bank told analysts this month at an industry conference,

> *"I think anyone who's not looking at their own liquidity assumptions is making a mistake."*

And as the chairman, president, and CEO of a large regional bank headquartered on the east warned, it will not be just the LCR bank treasurers are going to need to think about. They will also need to capitalize negative AOCI in their regulatory capital.

> *"On LCR…my expectation would be that they're going to push that far down the curve…They're going to -- you're going to have to include AOCI in your capital ratios."*

But there are some differences between the events in the repo market on September 16-17, 2019, and today. Circuit-breakers have been installed to prevent another disruption in the Treasury markets as occurred back then, notably the Fed's SRP, which is a new tool the Fed established to keep the Treasury markets stable. The SRP helps primary dealers facing a cash shortage in the repo markets, and now we have the BTFP.

Launched last March 12th and run from the discount window, the BTFP is a lifesaver for a bank in funding distress. Under its generous terms compared to the terms the Fed lends at its through its regular discount window, or compared to the terms it offers dealers with its SRP, the Fed will finance 100% of the face value of Treasury and Agency MBS at the Overnight Index Swap (OIS) rate plus 10 basis points for one year. It still hurts to pay that rate on bonds that are paying 1.5-2.0%, but at least banks that need the money do not have to realize a loss against their capital.

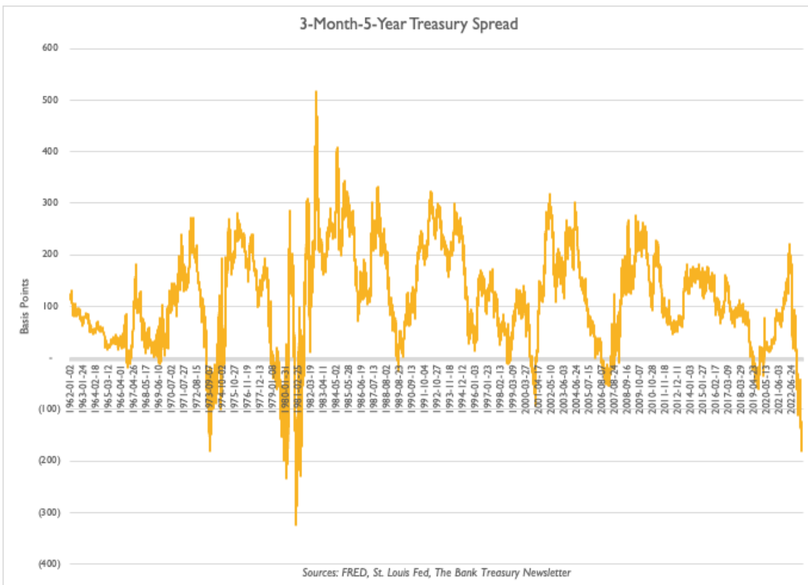
As of the June 7th, the balance of the BTFP equaled $100 billion, but according to public releases by banks that were borrowers at the end of March 2023, just a handful of institutions account for a significant chunk of the balance in that facility. At as it stands, the BTFP is only a temporary facility slated to end in March 2024. FRC, which reported earnings for Q1 2023, was at the top of the list of borrowers with $14 billion under the facility.

Of course, bank treasurers have many other resources to fund their balance sheets without having to go to the Fed. There is the Federal Home Loan Bank, and its advance product is a first choice for bank treasurers needing a short-term funding solution. But, if the Federal Housing Finance Authority (FHFA) guidelines for the Federal Home Loan Banks (FHLBs), 12 CFR Part 1266.1, which states that a FHLB *"shall not make a new advance to a member without positive tangible capital unless the member's appropriate federal banking agency or insurer requests it,"* complicates those contingency funding plans for some banks, bank treasurers have many other choices in their funding toolkit.

For example, they can tap the brokered CD market, or if they are concerned about their bank examiners looking askance at a funding strategy that relies on "hot money," they can tap into reciprocal deposits, where a bank treasurer takes a large deposit and effectively syndicates it into smaller $250,000-sized chunks of insured deposits. Though there are some similarities with brokered CDs, reciprocal deposits are excluded from the definition of a brokered deposit under the provisions of the 2018 "Economic Growth, Regulatory Relief, and Consumer Protection Act." The balance of reciprocal deposits tripled in Q1 2023, to $19 billion, but like the BTFP, just a handful of banks including FRC, accounted for half of that balance. (See Slide 12 in the chart deck for more details.)

None of these circuit-breakers would be enough to withstand an overnight deposit run, but at least bank treasurers can take some comfort that they may help at the margin. But if bank treasurers can make it through T-Bill-megeddon and another six months of QT, the spread between 3-month T-Bills and 5-year Treasurys presents a more existential risk that will be harder to navigate. The last 60 years of this spread through multiple rate cycles is shown in Figure 1 and the first point to make, which should seem obvious here, is that the negative inverted spread is the most negative it has been in 40 years. At its most inverted right after FRB failed, the spread was minus 180 basis points. Post the latest inflation report and anticipating that the FOMC pauses this month, the spread flattened to less the minus 130 basis points, but still poses an obstacle for bank treasurers to make loans or price deposits. (The volatility in the yield curve is also a problem as highlighted on Slide 5 in the chart deck.)

Figure 1: 3-Month-5-Year Treasury Spread



An inverted yield may or may not presage an economic recession. Bank treasurers tell the newsletter they think even if there is a recession, it will be very mild. At least, most of them think that, but bank treasurers read the same Wall Street estimates as anyone else, and none of those have been any good. Business leader surveys these days forecast slow growth ahead but no recession, and the chief executives of the largest banks who spoke to analysts this month were worried about a slowdown or a very mild recession at worst. The president and CEO of one of the global banks said he was pleasantly surprised about the economy,

> *"From what we see, things still are probably far stronger than we would have thought they would have been at this point in the cycle. There's still a fair amount of cash in deposit accounts. Consumer-spend is holding up…Now we're all looking out to what happens as the environment continues to be impacted by higher rates. But to this point, things are still okay."*

The chairman, CEO, and president of another one of the global banks was not seeing a recession on the horizon, more of a slowdown. From his perspective, the Fed did not need to raise rates anymore, *“Consumer…spending…in the last 3 months, it's fallen from a 9% growth rate year-over-year to 3%...And when you go on the commercial side, you see that line use is flatter now and that there's not as much demand out there. And obviously, the most rate sensitive things, homes and autos and stuff slowed down…You see all the inflation statistics tipping over. I think the Fed has largely done the task…They've done enough. You're seeing the signs…The near-term data is saying even though employment is pretty strong…wage growth is slowing, employment, new claims are up a little bit. You're seeing it start to come through the system and things like spending at restaurants…Is down to 3% year-over-year growth versus 17% 3 or 4 months ago.”*

The Fed does not seem so done yet, but the point is that spending is still growing, as are wages, and last month, so were jobs. What kind of a recession is that? But the chairman, CEO, and president of large regional bank headquartered on the east coast was forecasting a mild recession,

” We expect a shallow recession. I'm still waiting for somebody to define for me what exactly that means. But we're assuming fourth quarter, first quarter negative GDP, unemployment will rise to 5% towards the end of '24. The Fed may or may not be done. We're less worried about what happens in the front end than we are what happens in the back end of the curve…But no big credit surprises, no big dramatic changes in the economy, but a general slowdown…is our base case.”

And the problem with the back end of the yield curve is that it is inverted which makes two things very difficult for bank treasurers, pricing loans and retaining deposits. An inverted yield curve, especially one as deeply inverted as the yield curve in Figure 1 is today, makes it very difficult to bid competitively for deposits. If a bank treasurer looks to the belly of the yield curve where the 5-year Treasury today is yielding 3.9%, no amount of interest rate swaps or other financial “make-up” can let that treasurer pay a depositor much more than 2%, and that is still going to hurt NIM.

By the same token, an inverted yield curve makes it very difficult to price a loan when the marginal cost of funding is the 3-month rate at 5.3%, the borrower expects a rate of the 5-year plus 250 basis points, and at that spread the loan is not accretive to the margin. It certainly does nothing for shareholder value, for whose benefit the bank treasurer could have redirected the money it would have lent out and stuck it at the Fed instead, earning 5.15%.

The good news for bank treasurers, especially the ones at relatively smaller banks under say, $10 billion, who have large uninsured depositors they worry might pull their money out of the bank and put the proceeds in T-Bills or a money market fund, the data in Figure 2 from Q1 2023 call reports suggest that they might worry a little less.

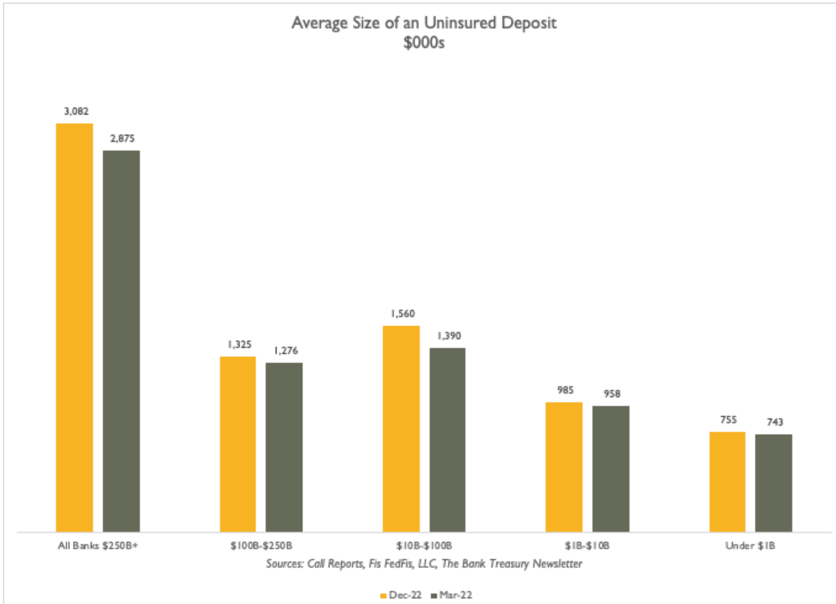
Uninsured deposits at banks with total assets over $250 billion, for example, shrank by 2%, and were down 5% at banks with total assets under $10 billion from the end of Q4 2022 through the end of Q1 2023. Only banks with total assets between $10 billion and $250 billion saw the highest outflows at 10%, and that peer group included FRB which filed a Q1 2023 call report before it failed.

The key point in Figure 2 is that the average uninsured depositor was not just leaving one bank for another bank or leaving banks entirely and going to a money fund. There was certainly some of that going on after SVB and SBNY failed. Uninsured deposit accounts are defined in the call report as deposits accounts with a balance greater than $250,000 excluding deposits tied to retirement accounts. The number of such accounts fell from 7.0 million at the end of last year to 6.8 million by the end of March 2023. But in addition, the average uninsured commercial depositor diversified its deposit accounts across more banks, resulting in lower balances per bank. Which from the perspective of the bank examiner coming in to review a bank treasurer’s deposit funding strategy, is a good thing. Everyone in the bank space loves granularity.

That was how the CEO and chairman of a large regional bank headquartered in the northeast would describe the changes he saw in uninsured deposit balances last quarter, and most of that diversification had already happened,

> *"I think…the good news is a bunch of it has already diversified out. And you got some other monies coming back in. We actually -- what I liked about the first quarter, the period after SVB was, we had some bigger accounts diversified out. They didn't close their accounts, but they diversified. But -- at the same time, we opened commercial…deposit accounts, and we brought in small business accounts above our trend line. The granularity of the deposit base improved."*

Figure 2: Average Size of an Uninsured Deposit



A lot of the uninsured deposits are operational, which means they are sticky, as the chairman, president, and CEO of a large regional headquartered in the Midwest reiterated,

> *"I think there's so much focus on this insured, uninsured, I would argue that a lot of the uninsured is as stable as the insured, particularly those that are operating…We have a corporate trust relationship, serving the bond issuers and the bondholders. And those are sticky because we are the corporate trustee. Those are part of helping those companies run their day-to-day cash flows and part of the deeper relationship. They're not capital investment or customers seeking yield and flighty at the 2-basis point level."*

Besides, bank treasurers might worry about deposit outflows from T-Bill issuance and SOMA, but they are not yet that desperate for deposit funding to either pay up to keep money they do not need, or just to stockpile more cash they cannot use except to leave at the Fed. As the chairman, CEO, and president of a large regional bank headquartered on the east coast told analysts,

> *"Chasing deposits -- the next marginal dollar…through brokered money…is a -- bluntly, it's a fool's errand when you don't need the liquidity, then everybody sees it's brokered money, and you're not doing anything for franchise value."*

It makes no sense to chase money you do not need, the chairman, CEO, and president of one of the large global banks said, *"The idea of chasing balances with higher rates when you really don't have anything to do with the money, is not exactly…. We'll pay for deposits when it makes sense at the customer level."*

And as the chairman, CEO, and president of a large regional bank in the southeast said, even if they have diversified their deposit balances around the banking system, depositors of all stripes, consumer and commercial, will not only leave higher deposit balances than they maintained before Covid, but will also leave higher balances in their demand deposit accounts (DDA) than before,

" Clients will keep more liquidity…I fundamentally believe…people are going to keep more liquidity…People came through the financial crisis…seeing the volatility today…I could be wrong, but I…think there's going to be some additional level of liquidity that clients want to retain…that shows up in DDA."

The bond portfolio is one of the last, but not the least important item on a bank treasurer's wall of worry, and that is because there really is not much that can be done about a bond portfolio that is as underwater as bank portfolios are these days. According to the latest FDIC data, the average available-for-sale portfolio was underwater by about 13% of book value. You can take the loss up front, you can add in pay-fixed swaps, do anything you like, but ultimately the choice is to rip off the band-aid and take a loss or do it slowly, bleeding it through earnings until the bonds finally mature at par. The chairman, CEO, and president of a large regional bank headquartered in the southeast would rather wait for the bonds to mature,

"The best thing for our shareholders is to let it burn down. Not to…take a loss and put us behind in capital."

Even though it seems that it might be good for shareholders to protect NIM against rates down, because one might hope that after the Fed pauses, inflation will continue falling, and then everything will be okay because the Fed will start cutting rates in 2024, the most important thing one can do for shareholders is to protect against rates up. As the chairman, president, and CEO of a large regional bank headquartered on the east coast said,

"The issue today is the downside risk to banking as rates go up, not rates go down…I'm not worried about rates falling. I'm worried about rates going up even though I don't necessarily think that's the highest probability. You always -- and in a world like this, you protect against the worst outcome, and that's if rates rise."

Worrying about shareholders is the least of a bank treasurer's concerns, because at the end of the day, there is no way to avoid the reality that banks are destined to hold lower yielding assets, lower leverage, and produce lower returns. According to the chairman, president, and CEO of the large regional bank headquartered in the southeast, the only thing bank treasurers can do is to do better than their peers, to strive to be best in a bad situation.

"We'll operate at a higher capital level…and you'll see some pullback in ROEs. I think the construct of our business, the diversity of our business model, the lower risk model we run, I still think we should be able to be top quartile kind of return."

There is no escaping reality as it is today, but as the chairman, president, and CEO of the large regional bank on the east coast warned analysts this month, banking is not about the next quarter's NIM. Bank treasurers must do what is right for shareholders over the long-term, as well.

"Look, in the end, the mathematical outcome of having to hold a point more of capital is less return on equity, all else equal…That return on capital number, this fictitious number that you stare at every year has nothing to do with the reality, unless you mature the balance sheet. Be careful throwing that number around for some annual period…because the balance sheet is a long-living thing as we've all discovered here in the last year. It's not about next quarter's NIM."

Bank treasurers have their wall of worries, to be sure. But at least, tucked away indoors, they can worry about them in a clean, air-filtered, climate-controlled environment. Good thing their work does not involve having to go outside.

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