The Bank Treasury Newsletter

The Federal Deposit Insurance Corporation (FDIC) released a report this month reviewing its supervision of First Republic Bank (FRB) and what it had learned. It had already published a similar analysis on Signature Bank, New York (SBNY), and the Federal Reserve also published its own analysis on Silicon Valley Bank (SVB). In all three reports, bank supervisors acknowledged that the deposit runs against SVB, SBNY, and FRB were fatal, regardless of whether the management deficiencies they had cited had been repaired. But in the case of FRB, according to the FDIC, management was an A+ student and the examiner rating on liquidity was upgraded in the 2022 bank exam to a "1." Examiners were mindful of the bank's large reliance on uninsured deposits, but believed the deposits were sufficiently granular to mitigate much of the funding risk they posed if the bank were to lose a large deposit. Misjudging the stability of its deposit base, FRB was prepared for liquidity stress scenarios over 30-, 60-, and 90-day periods, but not over 1 day. The FDIC also conceded that examiners failed to consider the power of social media to cause a bank run in a financial system set up so that deposits can move in the literal blink of an eye.

The bank failures cost the Deposit Insurance Fund (DIF) $25 billion according to the FDIC's estimates, which reduced the DIF to 1.1% of total insured deposits at the end of Q2 2023. This is 25 basis points below its statutory minimum of 1.35% which it is required to meet, if not exceed, by the year 2028. Banks with total assets over $50 billion will assume 95% of the burden to replenish the DIF, and the special assessment will not apply to banks with total assets under $5 billion. The FDIC proposed the special assessment to start in Q1 2024 at an annual rate of 12.5 basis points paid over eight quarters. While the Basel 3 Endgame only applies to banks with total assets over $100 billion, the Federal Reserve has already ramped up enforcement actions against community banks requiring them to address interest rate and liquidity management deficiencies, filing 11 such actions just since last May. Since the Fed began raising rates in March 2022 until last May, no such enforcement actions citing interest rate risk or liquidity management deficiencies had been issued against any institution large or small, and these issues were rarely cited as the basis for such actions even before that.

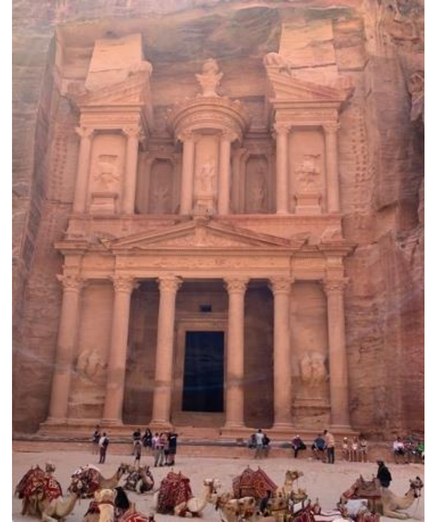
SVB's investments in mortgage-backed securities (MBS) have been widely criticized as poorly timed and ill-suited for the deposit and broader funding profile it had, but FDIC quarterly data going back for 158 quarters to Q1 1984, through multiple rate cycles, shows that excess deposits consistently left in a bond portfolio with about a five-year duration will outperform an equivalent investment in a money market account. FDIC-insured banks reported cumulative interest income earned on investment securities equal to $3.2 trillion through Q2 2023. If bank treasurers had kept a portfolio of 3-month Treasury Bills instead, they would have earned $1.9 trillion. However, for the first time in the series, since Q3 2022, the bond portfolio has been significantly underperforming such a hypothetical T-Bill portfolio.

Negative Accumulated Other Comprehensive Income (AOCI) continues to pose a significant threat to future long-term earnings. Bank treasurers face a bleak choice between selling underwater securities, incurring a hefty loss, and taking advantage of an inverted yield curve to earn back the loss over three years. Or, holding onto the bonds, they could stick to funding low interest-earning assets with high interest-bearing liabilities. If in addition to the bonds in Available-for-Sale (AFS), mark-to-market were applied to bonds in Held-to-Maturity (HTM), the additional hit to capital would equal more than 13% of total nominal book equity based on aggregate Q2 2023 FDIC data.

The message from the largest banks to the analyst community going into Q3 2023 earnings season is that deposit trends are doing better than expected, while loan funding pressures subside as demand for credit eases. According to H.8 data, for example, deposits at large banks were flat compared to the balance at the end of Q2 2023, at $10.0 trillion, while deposits at small banks increased by $0.2 trillion to $5.3 trillion. Bank treasurers continue to cycle out of Federal Home Loan Bank (FHLB) advances into retail brokered CDs as a more efficient source of longer-term supplemental funding.

BANK TREASURERS HAVE LONG MEMORIES

Dear Bank Treasury Subscribers,



You get here by first crossing the border from Eilat in Israel to Aqaba in Jordan and then driving north into the Arabian desert for three hours. Make sure to bring along a lot of water, but there is a rest stop along the way where you can rehydrate with an espresso, a delicacy in these parts where water must be imported from Aquafina and Poland Spring. There is not enough rainfall all year to fill a single demitasse with water, so thank you, global economy! But if espresso is not your thing, do not bother asking for a "Tall," "Grande," or "Venti" chai latte. Shockingly, there are no Starbucks in the desert.

When you reach its gates, you will need to walk for a third of a mile down a narrow, dusty, rock chasm lined with stalls where locals are selling tourist tchotchkes. Alternatively, you can ride on a camel to your destination, as a line of drivers will offer you a "good" price to take you. It will not be much, they will tell you, only about $100, or 71 Jordanian Dinars if you have those, and there is an ATM up the block if you do not. Be careful, though, maybe get the offer in writing, as the camel drivers are notorious for demanding additional money to let you off the camel after you have gotten on. (Like all markets, it is all about who needs who and when they need them.) Finally, you proceed, and as you do, faint strains from the theme song from Lawrence of Arabia play in your head.

Petra. It was a major trading hub on the ancient Middle East spice road, but it and the Nabataean civilization that carved it out from the red sandstone formation in the desert were lost to history when an earthquake struck in 363 A.D. leveling the city's vitally important aqueducts. It was a game changing, existential, paradigm-shifting catastrophe, upending a city and a civilization that was rooted here for centuries. Your editor-in-chief can only surmise that the banking system, such as it was back then, probably also got clobbered, a victim of operational risk. Oh, the horror! And if any local banks survived, our readers could expect the capital charge they would have had to cover to stay in business after that would have killed them, judging by the proposed Basel 3 Endgame rules for operational risk that came out this past summer.

But even ignoring bank regs, it is easy to see why Petra was abandoned, forgotten, and lost, the civilization that built it leaving behind a ghost town as empty as the office buildings standing in Midtown Manhattan, the Chicago loop, and on Market Street in San Francisco. After all, who would want to come to a barren, dry place without running water and hot morning showers? It would be worse than coming back to work after Covid, but finding your favorite clothing stores, pharmacy, sandwich shop, and salad bar you used to like to patronize still closed and empty, a tattered "For Rent" sign in the window.

So, there was nothing here for a long time. And then, in 1812, a Swiss explorer named Johann Burkhardt "found" it. Treasure hunters have been flocking here ever since, along with the falcons and sparrows that circle overhead.

It comes into view at the end of the trail. Al-Khazneh, "The Treasury," according to Google, is one of the seven wonders of the world, and a world heritage site as declared by the United Nations Educational, Scientific and Cultural Organization. With four thick fluted columns in the front, the building certainly could be mistaken for a bank branch, or at least a place where money was kept for safekeeping and where bank treasurers in ancient times worked to balance the

city's financial inflows and outflows. Indeed, Greek revival used to be a thing with bank branch designs, an architectural projection of an institution's solidity, its conservativism, and respect for tradition. Columns in front of a bank branch promised depositors safety and stability. Surely then Al-Khazneh must have had something to do with money.

Today bank depositors depend on the FDIC and the DIF to guarantee their money's safety, never mind in God we trust. And if uninsured depositors and shareholders put their faith in anything tangible, it would probably be tangible common equity, a key issue in the bank treasury world where negative AOCI can knock points off from capital ratios, and even render some banks technically insolvent under Generally Accepted Accounting Principles.

Branches may still be a necessary cost of doing business, but in a business measured in basis points, infrastructure and equipment are still noninterest-earning, capital-intensive assets. Which is why each of the 71,190 remaining bank branches in the U.S. today are more likely to resemble a "hole in the wall" than a column-faceted temple to money like Al-Khazneh. After all, the comparative costs to put investment in physical infrastructure instead of a mobile app cannot be ignored. Not when bank managers are laboring 24X7, line by line through their 2024 budget plans to boost returns in line with risk-weighted asset (RWA) optimization and expense rationalization strategies.

And bank branches that do look like those old branches with the columns may not be doing business as bank branches anymore. About half of the bank branches that are closed and not sold to another bank get repurposed into restaurants, retail stores, and health clinics according to a study conducted by ELFIN, a commercial real estate brokerage based in Louisiana.[1]

Ironically, the Treasury building may be a very solid, very old structure, it may look like a temple to money, and judging by some of the cracks in the columns that have had to be restored over the years, has been through a lot of rate cycles. But as far as archeologists can tell, it has never had anything to do with the bank treasury business. Nothing. There is not a single shred of evidence that bank treasurers ever worked here. (Although if one looks at the typical bank treasury department, there really is nothing unique that tells you that bank treasury work goes on there, either, beyond maybe the sign off from the elevator directing visitors right or left). Still the name stuck, and treasure hunters are still coming.

There is no treasure, but there is a treasure. It may not be tangible, but it is here. Go ask the camel drivers and tourist stand operators, who hustled some of the $5.6 billion out of visitors who came to Jordan last year, 11% of Jordan's gross domestic product in 2022. The vendors here are happy to take all forms of currency and even have card readers for your convenience, though they prefer cash like everyone else. Did they mention the ATM that is up the block?

As mentioned, in its glory days, Petra sat astride a major trading hub, so money must have been flowing into somebody's bank account or treasure vault. And not all treasure is made of gold. Salt was a form of money back then, too. The air here is redolent with it. It is the reason Al-Khazneh is still standing for what archeologists believe has been more than 2,500 years and is a treasure that is still generating economic value for those who work here. History is well-preserved here, even the effects of the earthquake have not been erased by time.

At 131 feet tall, it inspires with its historical grandeur, imperfections, and all. Bank treasurers should come here on their next vacation. They will love the history, given their penchant for remembering every single bond they ever bought and regretted. Bearing ancient bruises on their sleeves suffered by their predecessors and predecessors' predecessors that have also not been erased by time, they are all about history. They need to make this trip when things finally quiet down at work, whenever that will be. They would appreciate the view if nothing else.

[1] https://elifinrealty.com/what-are-former-bank-branches-used-for-after-they-sell/

Bank treasurers love history, which is why they never stop bringing it up. Nursing long-held memories of mistakes they do not want to ever make again, even if they themselves have not been in their seat long enough to have personally made them, it is easy to imagine how decades from now future bank treasurers born this month will reflexively shudder when buying a bond, just thinking of the negative AOCI in their predecessors' day.

And the scars formed today are on top of scars formed from previous AOCI shocks, going back to the Global Financial Crisis. They go back further to 1994 when Alan Greenspan suddenly doubled interest rates to 6% rocking what bank treasurers had believed were carefully hedged balance sheets. And those scars go back even further in time to the early 1980s, when Paul Volcker jacked up rates to battle inflation. His hikes led to the failure of First Pennsylvania, the failure of a slew of banks in Texas, and a savings and loan crisis. Lessons learned from that time are still taught in bank treasury 101 training classes to this day.

Newbies learn early on that going long can get you paid but can also get you fired. Bank treasurers have enough institutionalized scars to appreciate that, buying bonds, going long rates--it is all great, until it is not. Just like now. And then it can be painful. In a flash an earthquake can change everything. Suddenly, the short-term matters, your bonus is cut in half, and everyone is yelling at you even before your morning coffee.

History goes back a long way in the bank treasury world, and so experience tells bank treasurers to focus on the long term, but to not ignore the short-term. Bank treasurers practice an ancient art. It is the art of balance. Bank treasurers balance liquidity and asset liability management against net interest margin (NIM) and net interest income (NII). Their boss wants both, so the job is never easy. So, it is easy for the CEO to blame the CFO who will blame the bank treasurer for going long during Covid. You can almost hear them yelling in the boardroom, the chairperson demanding who in their right mind buys 2% mortgage-backed securities (MBS) in 2021?

Obviously, and certainly in hindsight, buying MBS in 2020 and 2021 with 2% coupon rates was unfortunate, but given where rates are today, even bonds bought back in Q1 2019 are underwater, assuming those bonds did not prepay already. After all, rates have not been this high in nearly a quarter-century! Should bank treasurers just sit in cash to be safe? Eventually you need to venture out of the bunker and take a view on rates. This is why bank treasurers get paid, you know. They get paid to have a view, to make decisions, and be held accountable for them. That is the job of a bank treasurer.

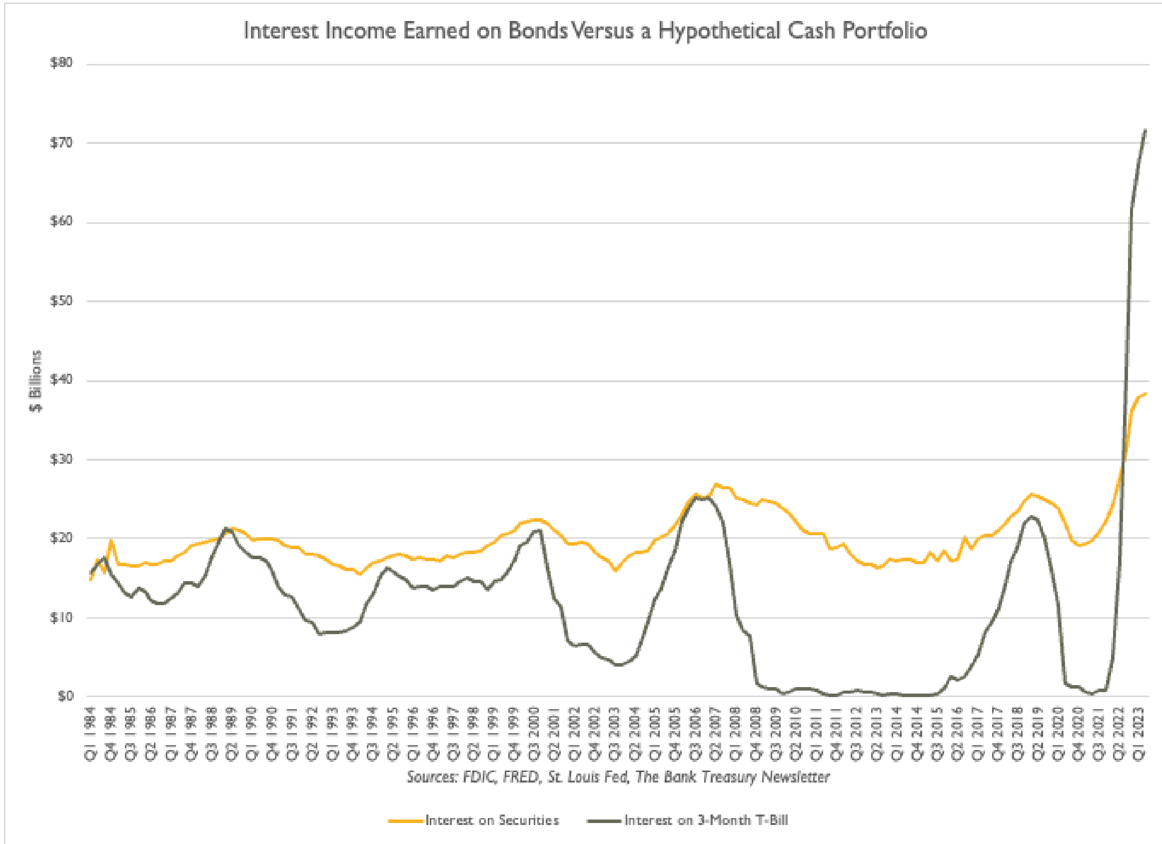
With an eye on history, bank treasurers could point out that, over the long-term, buying bonds did better for shareholders than sitting in cash. Figure 1 demonstrates conclusively that bank treasurers who chose holding bonds over cash as a consistent balance sheet strategy since Q1 1984 outperformed those who played it safe in cash. It compares aggregate quarterly interest income reported by FDIC-insured financial institutions on their bond portfolio to the interest income they would have earned had they sold their bond portfolio in Q1 1984 and kept the cash ever since, quarter after quarter for 158 quarters, in 3-month T-Bills.

Over 158 quarters, the bond portfolio grew from $652 billion in Q1 1984 to $5.6 trillion in Q2 2023 and cumulative quarterly interest income on the bond portfolio equaled $3.2 trillion. At the same time, the yield on a 3-month T-Bill went from 11% to 0% and is now back over 5%. Over the entire time, it averaged 3%. Hypothetically, if bank treasurers had put their money in 3-month T-Bills instead of the bond portfolio they held consisting of Treasurys, MBS, Munis, and some Corporates, with a 4 to 5-year duration, the industry would have earned $1.9 trillion in interest income, underperforming their bond portfolios in aggregate by $1.3 trillion.

Cumulative total interest income on bonds, loans, and other interest-earning assets going back to Q1 1984 equaled $19.5 trillion, so $1.3 trillion is not an immaterial number. And this difference includes the last four quarters, when for the first

time in history (at least going back to Q1 1984) a cash portfolio of T-Bills cumulatively outperformed the interest earned on the bond portfolio. A 3-month T-Bill position over the last four quarters would have generated $97 billion more interest income than the $144 billion generated by the bond portfolio during that period and would have outperformed in each quarter.

Figure 1: Interest Income on Earned on Bonds Versus a Hypothetical Cash Portfolio



Bank treasurers can argue with their CFO and CEO all they want about the long-term, but shareholders have short memories, the c-suite needs someone to blame, and who needs a bank treasurer anyway. Not to be harsh, but given where rates are these days, and where front-end rates are compared to the backend, you can just park cash in T-Bills and be done with it. The treasury department can be repurposed as a storage area, or maybe could be reopened as an employee café with the money saved from the treasury staff headcount cuts. Shareholders would get their buybacks and dividends.

Shareholders nursing short-term memories about negative AOCI, might also reply that even if holding bonds over cash paid better over the last “40 million” years, today is different and maybe the future will not revert to trend. Rates were falling for the last 40 years. That could be all over and rates could be increasing now, just like they did back in the 1970s and early 1980s. If rates had been rising and not falling for all those years, maybe the cash portfolio would have outperformed bonds by $1.3 trillion.

Bills or bonds, bank treasurers will need to keep shorter bond portfolios going forward, this seems to be the consensus from the field. As the chairman and CEO of a large regional bank based in the northeast told analysts this month,

"I think you've got to live with a shorter duration investment portfolio…I think that's probably the space that you would probably play in rather than doing 5-year type duration assets.

Everything is different about this cycle. History is important, but how relevant is ancient history? Why is this time different? Here are just a few reasons. Because there has never been:

a) Federal stimulus as sizeable and delivered in as concentrated a time as happened during Covid, which flooded the banking system with more deposits in aggregate than it has ever held relative to loans going back for 70 years.
b) as sharp a reduction in bank deposits in the space of a year as has just occurred.
c) a 525 basis point cumulative hike in rates straight off from the 0-lower bound in the space of 18 months, the equivalent on a relative basis of going from 0 to practically infinity.
d) an inverted (but slowly flattening) yield curve that has been inverted for longer than anyone can remember ever before.
e) an economy that has to date seemingly shrugged off tightening of monetary policy to a degree that previously would have leveled any other economy in the history of mankind.
f) the ability for money to move between banks and from banks to nonbanks literally in a blink of an eye.
g) the demonstrated power of social media to cause a bank run.
h) and finally, geopolitical tensions, and environmental upheaval of unimaginable scale for as long as it has been going on, coupled with crazy market volatility. Everything is still okay, but war, pestilence, and devastation cannot be good for anything in the long run. At least that is what history says.

This time is different. Because shareholders could complain that we are not just talking about interest income underperformance. Negative AOCI is an even bigger deal. It kills book value of equity and complicates exit strategies for bank treasurers that look at an inverted yield curve and do not see a viable way to generate shareholder value on an independent basis anymore. Buyer do not like underwater balance sheets. And never mind the business about how the Fed is going to start cutting next year and these AOCI problems will just be so much accounting timing mismatches. What if this time is different and the Fed keeps rates here forever, or at least longer than ever before. Huh? Did you catch Chairman Powell's press conference?

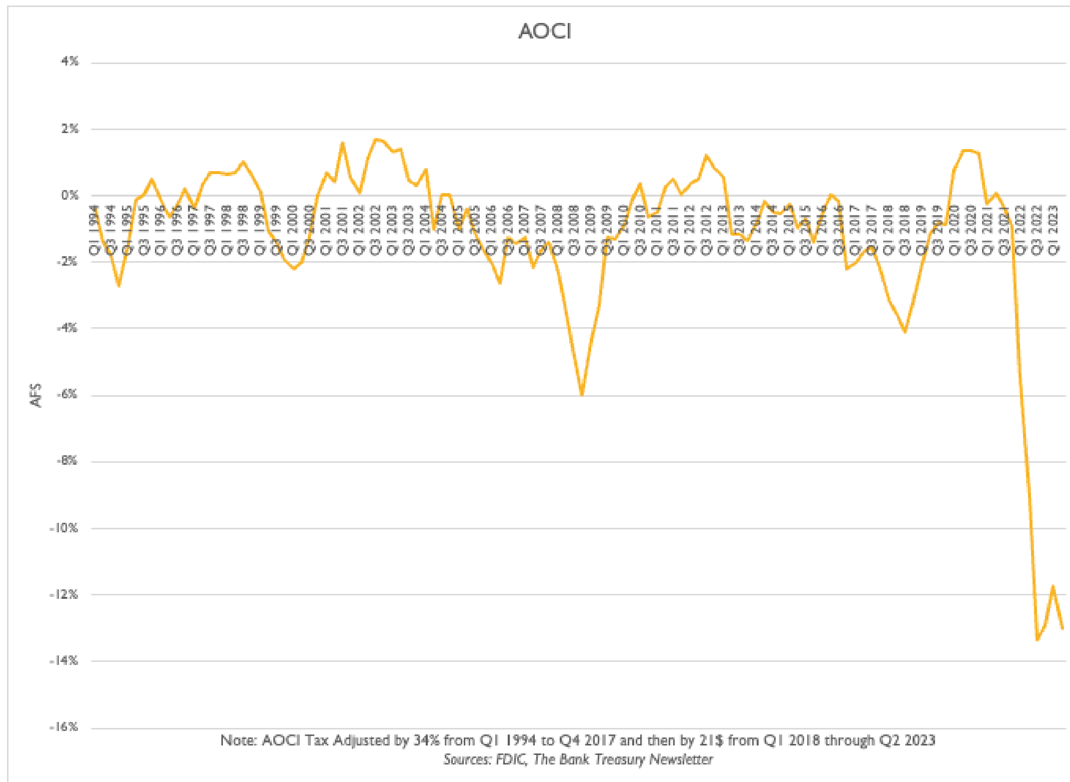
Negative AOCI was never as much of a big deal as it is now. Since Statement of Financial Accounting Standard 115 was first adopted in 1994, through multiple rate cycles, the scale of the adverse mark-to-market on bank bond portfolios has never been as devasting to shareholder value as it has been in this cycle. AOCI, adjusted for the corporate tax rate in Figure 2 equaled more than 13% of AFS, which totaled $2.8 trillion at the end of Q2 2023. Together with the HTM portfolio, total securities equaled $5.4 trillion. But unlike AFS, HTM securities are reported at historical cost.

If the same mark were applied to HTM as applied to AFS, the resulting unrealized loss on the total portfolio would equal 26% of nominal book value equity which equaled $2.2 trillion at the end of Q2 2023. And remember, bank treasurers do not report mark-to-market on their loan portfolio except for the loans they are selling. If the CEO and chairman are shocked that anyone could buy bonds during the pandemic with a 2% coupon, wait until they get a load of the yield on the fixed rate loan book they own.

From the FDIC's perspective, which ultimately is the taxpayer's perspective, if a bank failed tomorrow, the difference between market and amortized cost is a write off against equity and ultimately against the DIF. The DIF, the FDIC reported this month, fell by $13 billion in Q2 2023 to absorb the loss on FRB, on top of the $12 billion loss to cover SVB and SBNY in March. The DIF, at 1.1% of total insured deposits, must be over 1.35% by 2028. As far as the FDIC is

concerned, buying bonds was not worth the price. Bank treasurers should have just left their money in cash, regardless of the strategy's underperformance from the shareholder's perspective.

Figure 2: AOCI % AFS Securities



But in the wake of SVB, SBNY, and FRB, bank supervisors are not running around telling bank treasurers where to put their money. Nor are they telling them how to model their deposits. Or how much liquidity is enough. And bank treasurers have another thing coming if they think that they can buy off their bank examiner's concerns with a bigger pile of liquidity. Because the failure of SVB, SBNY, and FRB was an earthquake, as much for bank treasurers as for bank examiners, and what bank examiners want to know from bank treasurers right now is if they experienced the same thing.

"Did you just see what we just saw? Are you worried? Because we are stunned." That is what bank examiners are saying to bank treasurers. Bank supervisors are questioning everything, every assumption of what they had believed was up and down about what makes a bank safe and sound. Are all uninsured deposits a flight risk? Are core deposits still core? How should liquidity be measured? They do not want to see the pile of high-quality liquid assets (HQLA) you have on your balance sheet or care how many more pages you added to your bank's new and improved contingency funding plan (CFP). They want to know how you know that the pile is sufficient to avoid failure, and that you have tested the CFP under even the most far-fetched scenarios to make sure it works.

They want to know that you are taking what happened seriously, making you question your own assumptions and not just responding to requests from nervous examiners and checking boxes. As for the largest banks that are preparing for higher capital and Total Loss Absorption Capacity (TLAC) capital, it will not be enough to do what is expected, but to demonstrate that the bank can survive when what happens is not expected. Given the cost to the FDIC, the large banks are essentially large passenger jets and bank supervisors are the Federal Aviation Administration asking bank treasurers to pilot the plane and prevent a crash under all circumstances, even if the wings fall off and the engine stops.

Because you can never predict risk, and if history tells you anything, it is that in the bank world, you never see coming the risk that breaks the bank. The FDIC examiners were equally blind, as they conceded in their report that they published this month on the failure of FRB. As the FDIC admitted,

> *"…the speed with which depositors withdrew funds following SVB's failure was unexpected and surprised banks and the regulators."*

And going into the crisis last March, bank examiners believed that, unlike SVB and SBNY, which they complained had inadequate risk governance, liquidity management, and interest rate risk control, FRB's management team was professional and doing everything right. The FDIC believed that,

> *"… bank management was strong and had a good track record, had mature risk management and control systems, and was responsive to examiner feedback. As a result, the dedicated team appeared to have confidence in bank management and accepted management's strategies and assumptions."*

To be fair, what happened in the last 18 months has been without precedent. History is no guide and tried and true methods of managing deposits suddenly proved inadequate,

> *"Banks, such as First Republic, employed liquidity stress tests that were based on deposit outflows occurring over a 30, 60, and 90-day period, and that did not contemplate $40 billion in outflows in a single day. In retrospect, it does not appear that banks or banking regulators had sufficient appreciation for the risks that large concentrations of uninsured deposits could present in a social media-fueled liquidity event…The 2022 interest rate environment—the almost 500 bps increase and inverted yield curve—and the March 2023 uninsured deposit instability, represented a paradigm shift for FRB and other banks. Previous strategies for increasing the "stickiness" of deposits no longer held true."*

Even bank supervisors found themselves overmatched by the scale of the upheaval. Speaking at a Brookings Institution conference last month, Dan Tarullo, the former vice-chair of bank supervision conceded that bank supervision only goes so far,

> *"Supervision can fill in regulatory gaps, but not gaping holes."*

When bank treasurers meet with their examiners, they need to be aware that standard metrics are suspect. Yes, uninsured deposits are inherently less stable than branch-based deposits, that is indisputable. But there are steps you can take to mitigate the risk. Unfortunately, in the case of FRB, none of them proved adequate to save it.

> *"Risk mitigation centered on well-developed large depositor client relationships, which typically involved multiple service offerings that tended to reduce the portability of the deposit accounts…the top one percent of client relationships (balances greater than $6.6 million) were composed of 2,900 unique client relationships and represented approximately $73.3 billion of uninsured deposits. These relationships possessed several characteristics that indicated a strong likelihood of continued stability, including an average account tenure of 8 years, 24 services per relationship, and 59 percent of relationships having loans or private wealth management accounts."*

Historical experience proved useless this time,

> *"Uninsured deposits should not automatically be considered volatile; however, the historical and projected stability of uninsured deposits should be assessed. Risk Management Supervision considered the historical attrition rate of uninsured deposits; however, historical attrition did not end up being an effective predictor of deposit flight in the wake of SVB's failure."*

Stung by their surprise, bank supervisors are on the warpath. It is not just the large banks in scope for the Basel 3 Endgame that need to pay attention. Since last May, the Fed issued 11 enforcement actions against community banks citing interest rate and liquidity management deficiencies. The stepped-up enforcement is a sea change in the bank supervisory world, as enforcement actions like this are generally without precedent. It reflects a heightened skepticism by bank examiners when meeting with institutions, even ones which they have previously applauded as strong and well-run.

Bank examiners also have a new degree of empowerment today compared to recent years when bank managers were the ones who were empowered, dismissing examiner guidance as not binding. As Dan Tarullo noted,

> *"The banking agencies …adopted a rule that line supervisors perceived as an order to lighten up on the banks. They were told they needed to have more extensive documentation of problems at banks before they could take supervisory action."*

Bank treasurers like to say that they run their balance sheets with neutral sensitivity to interest rates, but privately concede that they always have a view. That view is that the Fed is finished with rate hikes and will bring rates down next year. After listening to Chairman Powell's press conference this month, maybe that timeline extends, but nevertheless, rates are going lower they believe, not much higher. To prepare, they are adding forward starting swaps, which are less capital intensive than investing in bonds but still buys some of the insurance they are looking for at this point to protect their NIMs and NIIs.

Without gainsaying the importance of a point of view, bank treasurers also need to understand their balance sheet's interest rate risk position, something bank examiners are not so sure they really know as well as they think and say they know. Facing a future where earthquakes can happen when you least expect them, bank treasurers intent of adding duration should assume that their examiners are skeptical of their plans and their timing. Buy bonds now? The chairman and CEO of one of the Global Systemically Important Banks (GSIBs) was not a buyer of bonds here, telling analysts this month at an industry conference,

> *"I would not be a buyer of Treasuries at 4.2%, much less a buyer of credit spreads at these levels."*

Even if bank treasurers who are fixing to buy bonds someday can explain their thinking on their balance sheet position, confidence in the future for any length of time seems speculative as the data remains all over the place and the Fed's monetary policy decisions are all so data dependent. Chairman Powell keeps everyone guessing, and he is guessing himself. And ask yourself this. If 525 basis points is not enough yet to cause the economy to roll over, why is even 6% too high? 40 years ago, the 3-Month T-Bill was 11%!

But then again, what goes up must come down, at least historically speaking as the saying goes. Maybe we are back to the 0-lower bound next year, which was the severely adverse scenario in the 2023 stress tests, and all those negative AOCI problems go away? And if you believe that the Fed is done and its next move is a cut, there is no need to sell bonds now to sit in cash. The bond portfolio's 2% coupon bonds are bleeding into NIM today, but the executive chairman, CEO, and president of a large regional bank based in the southeast, was all wait and see about selling them,

> *"Well, it's wait and see and being sensitive to what market conditions are and how people view it then."*

His bank holding on to an underwater portfolio bleeding into NIM, the CFO of a GSIB assured analysts that every dollar that trickles off from the bank's negatively convex MBS bond portfolio was and will continue to go into cash. But even with the memory and pain of negative AOCI from buying 2% bonds still fresh, he told analysts, one day the bank would still go back into bonds,

"We get pay downs every month from those securities. And...we're...sweeping them into cash. At some point, we'll put those into longer-dated investments."

There is no point in buying protection against lower rates in bonds or in swaps in today's market, the CFO from a large regional bank based in the Midwest told analysts, pointing to the inverted yield curve,

"I would say that at this moment in time, it's difficult to add substantively to downrate NIM protection strategies given the inverted yield curve and given a forecast of declining rates."

On the other hand, another GSIB planned to rip off the proverbial bank-aid and sell bonds right away in a transaction called a "sale and earn back," which given the inverted yield curve, the CFO explained to analysts, would pay back over three years, and would also meet RWA optimization objectives,

"This quarter, we decided to reposition the portfolio. We sold...bonds...because we saw higher levels of prevailing rates...to move around the duration position a bit that will put us in an attractive position. What we've done, the impact is that we've crystallized a loss for the quarter. Now that's already been through capital, right, because it was sitting in AOCI, so there's no impact on capital. And in fact, the trade is capital accretive because we're taking out a few higher RWA securities. And then what it will do is it will give us a payback on that -- on that as we reinvest those bonds at higher rates, more than 300 basis points higher than what they've been sitting at. And that will give us a payback within about 3 years."

One reason why some bank treasurers are even thinking about adding bonds at this point is that deposits have stopped falling. In fact, they are up a bit according to H.8 data. The small bank peer group increased its deposits by $101 billion from the end of June through the first two months of Q3 2023, or 2% (see this month's chart deck Slide 5 and 6 for more details). Deposit trends at large banks were flat. The chairman, CEO, and president of a large regional bank based in the southeast, who said before he was wait and see on selling bonds, was more definitive about his deposits and noted with hopeful optimism that his deposit rate betas,

"... are cresting. I don't know if they have crested, but they're cresting."

The CFO of another large regional bank based in the Midwest reported that stresses in the bank's deposits were normalizing,

"We see the deposit environment normalizing -- the competitive nature of the deposit environment abating from what it was in the first and second quarter."

The head of consumer banking at a large bank based in the northeast described the improving consumer deposit trend using some numbers,

"I'll give you a couple of stats. So, prior to COVID, our average customer had about 17,000 in deposits. At the peak of COVID that scaled up to about 24,000 and now it's...down to about 20,000. So, the consumer is in...a state of normalization."

Stabilizing was the way his boss, the CFO would describe the same trend,

"The main story here is stabilization. We're seeing stable deposit levels and increasing stability...Deposits have been quite stable over the last several months. So, we're feeling good about that.

The CFO of a GSIB was even more positive. Deposits are trending flat to up, a pleasant surprise on the upside,

"Our deposits are flat to up. That's a little better than we thought overall."

Deposits are a positive story according to the CFO of another large regional bank based in the southwest,

"We think deposits are a very positive story. We're quite happy with the trends that we're seeing there. Just as backdrop, you might recall that during the earnings call in July, we talked about the fact that deposits leveled off in the last half of the second quarter. Not only has that continued, but we've seen a nice uptick in deposit levels."

Better than expected, that was the way the president, chairman, and CEO of a large regional bank based on the East Coast described the trend with his bank's deposits,

"We're doing a bit better than we thought we'd do in terms of total deposits."

The president, chairman, and CEO of a large regional bank based in the southeast was not as hungry as he was before to hold onto deposits with rate incentives,

"We see very good momentum in our deposit trends…we have backed off some of the pricing initiatives that we had in the second quarter."

Even the outflows from noninterest-bearing deposits into interest-bearing deposits has been slowing down and should come to an end soon, according to the CFO of one of the GSIBs,

"We're starting to see is some burnout in non-interest-bearing deposit outflows. The largest clients with the most at stake have largely moved a lot of their non-interest-bearing deposits into interest-bearing. Some of the smaller ones, there's a little more movement there to go."

Not as bad as expected was the way the CFO from a large regional bank in the northeast described trends with his bank's noninterest-bearing deposits,

"It's leveling off. We're seeing our noninterest-bearing deposits down on a linked quarter basis but down much less than what we originally thought."

As the stresses in deposit funding ease and the memory of the crisis last March slowly fades, bank treasurers are letting Federal Home Loan Bank (FHLB) advances run off and replacing some with retail FDIC-insured brokered deposits. (See Slides 7 and 8 in this month's chart deck for more details.) The president and CEO of a mid-sized regional bank based in the Midwest told analysts that his bank was replacing some of his advances with brokered deposits as a longer-term more efficient form of supplemental funding to meet liquidity and asset-liability management objectives.

"Brokered deposits we as a lever for a few reasons. One, we thought it gave us the opportunity to…pay down some of our FHLB borrowings…During the crisis you had to make sure that you had 1-day liquidity…We thought that brokered was…a more cost-effective way than using the FHLB."

Aside from deposits, however, bank treasurers can appreciate the challenges they face. Let's face it, the business of banking does not really work with an inverted yield curve, as the CFO of a large regional based in the northeast said, hoping for a change in slope,

> *"The rate environment is inverted. That's not exactly the best environment for a bank that operates as a maturity transformation agent from the short to the long term. I think an upward-sloping yield curve is likely to be in our future again a couple of years out."*

And just because things are good today, does not mean they will be good tomorrow, the chairman and CEO of a GSIB warned, referring to the consumer who continues to spend and has powered the economy through 525 basis points of cumulative rate hikes,

> *"You have a pretty good economy. But there are huge buts here. People make a mistake to focus on current numbers and not look at the future. And the future has quantitative tightening. We've been spending money like drunken sailors around the world, this war in Ukraine is still going on. Those are big buts. To say the consumer is strong today, meaning you got to have a booming environment for years is a huge mistake."*

Meanwhile financial markets are becoming increasingly strained, as a report this month from the Financial Stability Board discusses.[2] Treasury markets may be especially vulnerable to shocks as the Fed shrinks the size of its reverse repo facility. Slide 12 in this month's chart deck also looks at the concentration of the top three dealers in Tri-Party/General Collateral Financing Treasury repo, which surged during Covid to over 70%, well above the average 46% for the last decade, and remains elevated.

Bank treasurers need to be ready for the unexpected, that sums up the situation. Earthquakes are not the only operational risk bank treasurers need to prepare for as climate change has posed some of its own operational hazards for institutions operating in the middle of massive fires, floods, and hazardously hot conditions.[3] Some scientists now believe that the Earth may be moving out of a "safe operating space" for humanity.[4] Something says that cannot be good for banking.

But everything turns, sometimes suddenly. Scientists recently identified ancient river beds in the Arabian desert that may date back to the last ice age. Remaining pools from these rivers may have filled oases which the Nabatanaean used to draw on to collect water to sell to thirsty Roman soldiers stationed in Petra. But those oases are lost today and a 1-litre bottle of Aquafina or Poland Spring is not cheap by local standards. Maybe climate change will bring back water to the desert.

Some enterprising locals run a cafe by The Treasury, with some aspirational signage announcing their Starbucks affiliation. Unfortunately, espresso is the only caffeinated drink on their menu. But who knows what tomorrow will bring. Starbucks may yet open up for business and you might just get that chai latte.

.

[2] https://www.fsb.org/2023/09/financial-system-remains-vulnerable-to-further-liquidity-strains-fsb-warns/
[3] https://www.cnbc.com/2023/08/28/wildfire-risk-electric-utilities-face-billions-in-liability-with-aging-lines.html#
[4] https://www.cnn.com/2023/09/13/world/planetary-boundaries-humanity-climate/index.html

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.

Copyright 2023, The Bank Treasury Newsletter, All Rights Reserved.

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