The Bank Treasury Newsletter

After seeing the Federal Open Market Committee (FOMC) raise the target range for the Fed Funds rate for the 11th time last month, to 5.25%-5.50%, bank treasurers expect the Fed is done or near done with raising interest rates for this cycle. They expect that their margin pressures will stabilize a couple of quarters after. Notably, Fed officials seem divided on further hikes. Governor Michelle Bowman this month said she expects *"that additional increases will likely be needed to lower inflation to the FOMC's goal,"* while John Williams, the president of the New York Fed and a permanent member of the FOMC, and Patrick Harker, president of the Philly Fed, and this year a voting member of the FOMC, both said they were less sure about further hikes. With conflicting comments like these, bank treasurers are nervous about the economic landscape and the risk that the Fed might have to pivot quickly to cut rates and cut them hard next year. But they are content to leave their remaining excess deposits in reserves earning 5.4% overnight, at least for now.

On a relative basis, treasurers at smaller banks are feeling the liquidity pinch from deposit outflows and competition for deposits more acutely than their larger peers. Excess deposits at large banks shrank by 25% over the last year to $4.0 trillion which raised their average loan-to-deposit ratio (LDR) from 58% to 63%. In March 2020, the LDR for large banks was 70%. Excess deposits at small banks, on the other hand, thanks to a surge in loans this year, shrank in half to $0.7 trillion, which boosted the group's LDR from 77% to 84%, just shy of the 86% it reported on the eve of Covid. See this month's chart deck Slide 4 for more analysis on excess deposit trends.

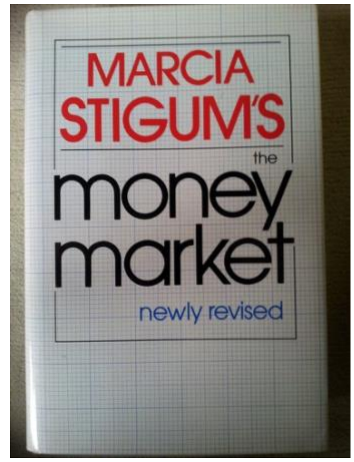
Money continues to shift around. Money market fund balances increased through Q2 2023 as the public shifted the make-up of its money supply from checking deposits (M1) to money market funds (M2). Thus, M1 fell by $2.2 trillion since the Fed began raising interest rates in March 2022, to $18.5 trillion, while M2, (which includes M1) fell by $0.8 trillion, to $20.9 trillion. The public is also shifting savings directly into Treasurys, adding to the drain on deposits, which will intensify this year according to the Treasury's latest refinancing statement. Money Market Deposit Accounts (MMDA) shrank by over $1.1 trillion since March 2022, to $5.4 trillion, and flowed into time deposits (See this month's Chart Deck, Slide 5 on recent trends with MMDAs and time deposits). Money market funds increased this year by $0.9 trillion, to $5.9 trillion, while checking deposits fell, but the ratio of checking to funds remains elevated, as the public is still sitting on a record level of cash in checking.

The industry's reliance on non-relationship funding increased in Q2 2023, including brokered deposits, to address its longer-term funding and liquidity needs created by the Fed's rate hikes and Quantitative Tightening (QT). The sudden failure of Silicon Valley Bank (SVB) and Signature Bank, New York (SBNY) last March exposed unappreciated weaknesses in deposit concentration risks and insufficiently prepared contingency funding planning which led in Q1 2023 to a surge in drawn advances and, to a lesser degree, in brokered deposits. But in Q2 2023, on a linked-quarter basis, brokered deposit balances increased while bank treasurers let run-off some of their drawn advances. Reciprocal deposits remain a limited funding option for bank treasurers, notwithstanding the fact that they increased by tenfold to $50 billion in the wake of the failure of SVB and SBNY. This is still half the size of the Fed's Bank Term Funding Program.

Bank supervisors this month unveiled their long-awaited proposed changes to bank capital regulations, which would widen the application of its most stringent rules to banks with total assets over $100 billion. Despite widespread industry concerns that the rules will reduce shareholder returns, and despite the urgency regulators signaled that the existing capital rules needed to be strengthened, the proposed changes will not even begin to take effect until 2025 and their transition period will not end until 2028. By then, most of the industry's record negative Accumulated Other Comprehensive Income (AOCI) problems will presumably have just amortized away back to par.

BANK TREASURERS REMEMBER MARCIA STIGUM

Dear Bank Treasury Subscribers,



Marcia Stigum finished the second edition of "The Money Markets" in 1983, five years after she published the first. It was an immediate, runaway, soldout, and backordered bestseller at Barnes and Noble and Border bookstores across the country. Addressed to money market participants in a plain language style that painstakingly avoided jargon and acronyms to describe a market that was and still is full of both, her 728 page tome of a textbook had its treasured place on office bookshelves, and if not there, for sure on the floor as a reliable doorstop.

Before there was Google, there was "The Money Markets." Her book was a go-to for bank treasurers, aspiring treasurers, portfolio managers, traders, salespeople, and every other fixed income executive. It was a compendium covering everthing you ever wanted to know about money markets but were afraid to ask without appearing ignorant.

It had descriptions on all the products you could imagine with a whole chapter devoted to the Eurodollar CD, which set the pulse of the money markets back then. This was before there were Fed Funds futures and swaps markets to write about, when the London Interbank Bank-Offered Rate (LIBOR) was king, and when there were only bi-lateral repo trades. Those were the days before tri-party repo or the Secured Overnight Financing Rate (SOFR). So long ago!

Those were the days when large money center banks roamed the banking terrain, much like today though back then they were lumbering giants that lacked their own core deposit funding base sufficient to fund the needs of their large corporate borrowers. In 1984, according to Fed data, the LDR for the average large bank was 80% compared to 60% for an average small bank. (See the analysis on excess deposits for large and small banks on Slide 4 in this month's edition of the chart deck for more details). To survive they had to feed off of the smaller, deposit rich and loan poor, regional and community banks in the Fed Funds market.Today their deposit funding profiles are reversed and that is not the only aspect of her book that is outdated. But in its day, it was a cornucopia of printed wisdom, providing readers with insights on the inner workings of a market that was generally opaque to the average investor, as much then as it is today.

Today, the book is a time capsule. Reading a physical copy of her book (because there are no e-book or audio versions, unfortunately) is to appreciate the research that must have gone into her original typewritten manuscript. It is a marvel to behold, how she pulled together sources in a world without personal computers, much less the internet, when fax machines were still a novelty, basically in a world lit only by fire and when dinosaurs walked the Earth. Based on interviews she must have conducted using a rotary phone for Heaven's sake, and no doubt many visits to the library stacks, she filled her book with detailed explanations covering all the major products and players in the money markets, a comprehensive guidebook addressed to both interns and veterans, alike.

She described the ebbs and flows of the Fed Funds, Treasury Bills (T-Bills), municipal notes, commercial paper, and repo markets, from their opening bell to their close. There were formulas for calculating the all-in-cost to issue a CD, the value of a basis point, and other useful bond math. It went through accounting. She went through the mechanics of running a bank's Euro operations and creating a bankers' acceptance. She deciphered market lingo, and explained why some go naked and others stay covered.

She had a whole chapter on the Fed, "the most watched player," and its history working with the Treasury before and after World War II, including a concise summary of the 1951 accord that established the Fed's mandate to pursue an independent monetary policy. It turns out relations between the Fed and the Treasury were not always so cozy. Who knew? There were two chapters on banks and their domestic and foreign operations that was mostly a discussion applicable to the money center banks. But basic principles remain the same for bank treasury, regardless of size. As she said,

> *"Every bank seeks to maximize profits subject to the constraint that perceived risk be held to some acceptable level. Also, in making asset and funding choices, every banks seeks to choose a balance sheet that meets this goal."*

The only difference between large and small banks were the products and range of strategies available to them from which to choose to meet their respective goals, a general operating philosophy as true then as it is today.

Dealers got their own chapter, which went into the mechanics of how to do an arbitrage in the money markets. There was an extensive discussion on auction tails, position limits, and something called the repo fail game. Failing to deliver is no longer a game since 2009, after the Treasury Market Practices Group began imposing hefty fines, but the history here is nice to know.

Money market funds also filled a brief chapter at the end. Invented in 1971, by the early 1980s the funds were just taking off with the public and were taking a growing bite out of bank deposits. This was because the Fed's rate hikes in the 1970s and early 1980s had bumped up against and then blew past the Glass-Steagall Reg-Q deposit rate caps, frustrating transaction account holders because banks were not allowed to pay interest on checking deposit accounts, while the unregulated funds, which offered the economic equivalent of a checking account, paid and paid well.

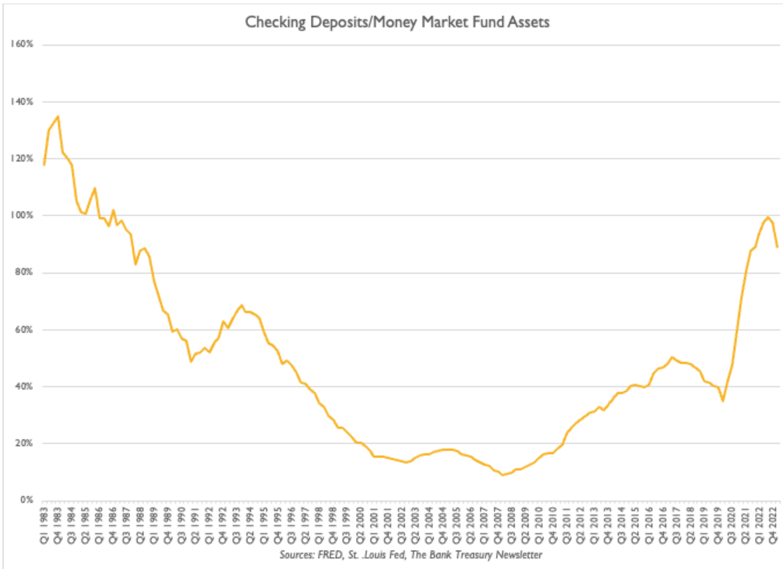
Banks tried to bridge the gap with their disgruntled checking account holders by offering them what was then a new, interest paying deposit product called a MMDA, which technically was and is a savings, not a checking account. But MMDAs were never much of a competitive response to the money market funds, a point Marcia Stigum made in her book. Paying a few basis points, the public must have had enough, given as it shifted $1.1 trillion out of its MMDAs in the last 18 months, leaving a balance of $5.4 trillion at the end of June 2023. Those funds went into time deposits, doubling the balance in that time period to over $2.2 trillion, but the public's money also went into the money market funds, which increased to a record $5.9 trillion at the end of June 2023.

But in 1983, the funds were just topping $200 billion and were fast approaching parity with checking account balances. In the decades that followed, the money market funds, gaining in popularity, quickly eclipsed checking as a primary vehicle for transaction savings, and that was the state of things for decades. Then came Covid, and then came the Federal stimulus and the Fed's Quantitative Easing (QE) 2, and then followed a surge in money supply and checking balances. For the first time since 1983, in Q2 2022 checking pulled back up even with the money market funds.

But then 11 rate hikes, QT, and the Fed's $1.9 trillion refinancing ambitions for this year began to drain checking balances, and the ratio of checking to funds slipped back below par. Compared to the previous 40 years, checking balances remain elevated relative to the funds, even after the failure of SVB and SBNY last March led to a rush out of banks and into the funds. Checking balances continued to shrink and the fund balances continued to expand through the end of Q2 2023, but the pace is starting to slow in Q3 2023 as some bank managers have observed (Figure 1).

Her books were required reading for bank treasurers. In 1983 she published "Managing Bank Assets and Liabilities: Strategies for Risk Control and Profit." a how-to, comprehensive guide for bank treasurers which explained step by step in her plain prose style everything one would need to know to carry out asset-liability management for a bank. And she aimed for a wider audience than just market professionals. Beyond dealers, bank treasurers, and professional investors, she wanted to speak to the general reader. The book, she wrote in her introduction, was addressed to *"…all others who have an interest in the market"* and she expected that *"…many of the readers of this book will be relatively new to the money market."*

Figure 1: Checking Deposits/Money Market Fund Assets



The problem was and still is that money markets are a fast-moving business, too fast moving for hardcover editions, a subject not even suited for paperback, but more for a looseleaf edition. She understood the problem. From 1978 to 1983, as she wrote in her introduction to the second edition, the money markets had *"grown tremendously—in many areas by a factor of three—and it has undergone tremendous, sometimes traumatic, changes."* And a lot had changed no sooner than the first edition had gone to print. Iran had a revolution, there were hostages, and it fought a war with Iraq. Oil prices soared and then collapsed. Ronald Reagan was elected president, but also before all that happened, Jimmy Carter appointed Paul Volcker to lead the Fed and wage a new campaign against inflation.

Paul Volcker brought on the vigor! Between 1978 and 1983, the chairman raised, lowered, raised, and lowered rates, he caused a deep recession, and he did it all to slay the beast. His independent monetary policy made a lot of ripples in the money markets, touched off an S&L crisis, led to major bank failures, including First Pennsylvania and Penn Square in 1981. Their failures shook the rest of the industry, Continental Illinois needed a bailout, and banks failed in Texas when oil prices collapsed.

The repo market also went through a big shake-up because of some bad timing by Drysdale Securities and Lombard Wall. The two boutique dealers were shorting Treasurys in 1981 and borrowing the securities from other dealers and banks in the repo market earning the overnight repo rate which at the time was higher than the coupon rate of the bonds they were shorting. If this sounds a lot like some other dumb trades that have transpired over the years that have come to tears, that is because Paul Volcker was cutting rates in 1983 which caused Treasury prices to rally and the two dealers to file for bankruptcy protection.

Never ever fight the Fed. How many times have market participants made that mistake? Dealers and banks that traded their bonds with the two dealers were left in unchartered legal territory to recover their collateral from the trustee, which led to a lot of changes in the repo market, including the development of tri-party repo.

But, back to Paul Volcker and the mayhem he caused. There was a silver lining. He did bring consumer inflation down to 3% in 1983 and investors who were sitting on cash back then could earn 8%-9% on a 3-month T-Bill if they wanted to visit the Fed's public window and submit a non-competitive bid in writing. Alternatively, they could use something called a telephone to ask their commission broker to buy one for them. Although consensus among bank treasurers is that the Fed's rate-hiking days are coming to an end and earning 8%-9% on a 3-month T-Bill anytime soon seems unlikely, the 5.4% yield available today for purchase with a 3-month T-Bill at the next auction on Treasurydirect.gov is not too shabby. For the risk reward, the 3-month T-Bill beats what a bank treasurer could earn today on a garden variety mortgage-backed security. Or for that matter, what that same bank treasurer's underwater mortgage backed-security (MBS) portfolio pays.

Paul Volcker focused on the money supply, just as Milton Friedman the economist had preached a successful central banker should do. Keep the supply of money on a tight leash, and inflation will take care of itself. That was the basic idea. But just as the money markets were fast-changing, so was the definition of money. In the years that followed, America discovered credit cards and other forms of money that blurred the lines between money, near-money, and less near-money, or in Fed lingo, M1, M2, and M3. This had serious implications for the conduct of monetary policy. As she wrote in her 1983 edition,

> *"The facts that it is impossible to measure the money supply at any time, and that what serves as money undoubtedly changes over time, throws into question the validity of making money supply a major policy target."*

The truth was, however, even Chairman Volcker was no purist when it came to money supply and monetary policy. As a Fed watcher she quoted told her,

> *"There is no question but that the Fed responds to short-run gyrations in the money supply. I think they align their 2-month growth targets to give them the policy that most closely follows the policy they want to implement based on the fundamentals of the economy—the unemployment rate, the inflation rate and so on."*

And a lot more happened after the second edition of "The Money Markets" was published, including the diminishing role of the Eurodollar, bankers acceptances, and the general business of trade finance. And in 1986, President Reagan signed into law a tax reform bill that limited the tax exemption on municipal bonds, making them a much less appealing strategy for generating returns in a bank's portfolio. So, the second edition quickly became outdated, and in 1989 she published a third and what turned out to be her book's final edition.

The Fed also had a new chairman, Alan Greenspan, who found the Fed's money supply focus increasingly unreliable as a measure useful for setting monetary policy, and ultimately, in 1993, 30 years ago last month, he abandoned the policy to go back to the approach the Fed had used before, tracking interest rates and focusing on the economic statistic releases, the equivalent of what Milton Friedman had described as driving a car facing backwards.

And then there were more developments in the money market world, including a financial crisis, a real estate crisis, and the adoption of Statement of Financial Accounting Standard (SFAS) Number 115, Accounting for Investment Securities, which sent copies of the 1989 hardcover edition to bookstore remainder piles or directly to papermills for pulping. But the truth is that her stardom and doyenne-status in the money market world had peaked after 1983 and after 1989 she and her books faded into obscurity. There were no obituaries to mark her passing in August 2003, save for a paid death notice by her family in a local Vermont newspaper. Safe to say, most no one working today in fixed income or the broader financial world has ever heard of Marcia Stigum, or her books, before reading about them here.

Which naturally should make our readers wonder why this month's edition of the newsletter is dedicated to her memory, and so much space devoted to discussing a book no one owns and an author no one remembers. Why should bank treasurers care about products and markets that bear little relation to the products or the markets that exist today, and or have any interest in events so far back in the past that they might as well have happened in the stone age?

The convenient fact aside that this month marks the 20th anniversary of her passing, there is something to be said for learning from history or being doomed to repeat it, and there is that whole business about history rhyming. It is certainly tempting to compare today's inflation statistics and rate environment to the circumstances prevailing 40 years ago when Chairman Volcker was fighting inflation, to see the past as prologue here, to try to figure out how things turned out back then to anticipate how they will work out today. As the Fed works to push inflation back down firmly under 2% and contain the public's price expectations, it is only natural to ask, "what would Paul Volcker do?" in these desparate, difficult, and distraught times.

But there is no ignoring the yawning differences between then and now, and something to be said for the fact that the money market world in 1983 and the one in 2023 look absolutely nothing alike. What can we really learn about how to address our struggles today in the financial markets from how our "ancestors" dealt with the problems in the stone age? This was an age when dealers literally had messengers take securities in locked briefcases to deliver paper certificates to receiving stations called cages; when a cell phone was a pay phone in a phonebooth.

Marcia Stigum's world as she knew it is gone. There is just no trace of it. The Eurodollar market? Gone, because the London Interbank Offered Rate (LIBOR) is no longer quoted, replaced instead by the Secured Overnight Financing Rate (SOFR) as of the 1st of July. The Eurodollar futures market? Gone.

The interbank market is a fraction of what it once was, effectively ended in the Global Financial Crisis (GFC) when the Fed flooded the financial system with reserves. Interbank deposits, the basis for the Fed Funds market, equaled less than $10 billion this month, about a third of what it equaled in 1983, when the banking system was less than a tenth of the size of what it is today.

The repo market is a key part of the money markets, but repo is primarily tri-party, not bi-lateral, and the money market funds and the Fed are its leading players. There was no Reverse Repo Facility (RRP) to speak of back then and it did not pay interest. The Fed did own Treasurys, but there was no System Open Market Account (SOMA). Treasurys were the only collateral financed in the repo market. Mortgage-backed securities were just being rolled out to investors in the early 1980s, and financing was done through dollar rolls, not repo.

Our worlds are different. There are no required reserves anymore. The Fed officially ended that requirement in March 2020. Wednesday is still a thing at the Fed, but the entire dynamic in the reserve market around Wednesday's scramble to settle reserves with the Fed, all that is over and was over a long time before it was officially ended. Reserves are still needed to make payments over the Fedwire and for liquidity purposes, and according to the Fed's latest Senior Financial Officer Survey Results that it published this month, respondents planned to increase their reserve deposits at the Fed. So, demand for cash assets is up. But with an ample reserve policy in place, end of day scrambles in the Fed funds market will be rare, provided the Fed does not overtighten, and with reserves at over $3 trillion, there does not seem to be much danger of that yet, even as QT passed the first its first $1 trillion milestone this month which reduced SOMA to $7.5 trillion.

In 1983, time deposits equaled nearly half of total deposits in the system, and today even after the balance doubled to over $2 trillion last quarter, they still equal only a little more than a tenth of total deposits, according to FDIC data. Time deposits were more than three times the size of checking in 1983, while today CDs equal less than half. The overall mix of bank deposits is fundamentally different than it was back then.

Interest rate derivatives, were also a novelty in 1983. The first fixed-to-float swap in the U.S. had just been executed the year before between the World Bank and Sallie Mae, before the latter was privatized, which was indexed to the 3-month T-Bill. There was no market yet to check where swaps and swaptions were trading. And even if there was a market, there were no screens to see bids and offers. That was still to come in the future because Michael Bloomberg had just left Salomon Brothers in 1982 to set up a financial data service firm, initially called Innovative Market Systems. The rest was history.

But the thing about her book is that, despite the fact that much of what she has to say is outdated, a lot rings as true today as it did then. There are certain laws of the universe, at least in terms of the financial markets and how to navigate them. Law number one would be that there is no such thing as a neutral interest rate position in bank treasury. Staying as short as possible in cash is as much a bet on the Fed's first rate cut as is buying a long duration MBS or some other long bond. Whether you are long or short, you are taking a position. Even hedging is taking a position.

And even an investent in a 90 day T-Bill is not riskless when it comes to interest rate risk. There is always the overnight rate if an investor wants to take zero risk of an imminent, say inter-meeting rate hike by the Fed, the kind of play that Paul Volcker pulled when he got on board as the Fed chairman in 1979 and then raised rates over the weekend by 100 basis points. As a money market trader told Marcia Stigum,

> *"The mistake many people make is to think that they do not have to make a forecast. But buying a 90-day Bill and holding it to maturity is making a forecast. If you think that rates are going to move up sharply and soon, you should be sitting in overnight RP, and then when rates move up you buy the 90-day Bill."*

But another great and timeless truism is that predicting the direction of interest rates is a perilous career move for bank treasurers, because they are bad at it. Even the Fed is no ace forecaster. Bank treasurers may bet against the forwards, and discount the risk of the Fed cutting rates in the next year, but then again, what else is there on which to base their forecasts? Even the Fed's own economists apparently were not very good at predicting interest rates and probably are not any better today than a prediction offered by the forwards. In other words, no one is smarter than the markets, but this does not mean that the markets are any better. As she related,

> *"Ralph Nader, in a freedom of information suit, forced the Fed to make public an internal memo that observed that the yield curve had a better track record at predicting interest rates than the Fed's own model."*

What would Paul Volcker do? He passed away in 2019, but if the late chairman were suddenly resurrected and reappointed to replace Jay Powell as the Fed chairman, he probably would be just as confounded by the resilience of the economy after a cumulative 550 basis points of rate hikes in the space of 18 months. He would also have to bow to his successor for topping even him in determination to wrestle inflation to the ground.

Using the 3-month T-Bill yield as a yardstick, when he stepped into the chairman's seat in October 1979, the 3-month T-Bill yield was trading around 11.8% and it peaked at 15.5% by August 1981 according to the St. Louis Fed's FRED. Over that space of time, the cumulative increase in the rate was a record that stood until Jay Powell's latest 11th rate-hike. And so far, he has succeeded in bringing down inflation even if the job is not done.

When Paul Volcker raised rates in the early 1980s, he caused a deep recession and the unemployment rate to hit over 10%. Last month the unemployment rate ticked down from the month before, to 3.5%, just 0.1% shy the all-time record low set last April. And, you would think 550 basis points would be enough to cause a sharp contraction in bank loans, yet experience in the last year proves otherwise, as banks continue to report slowing but still positive growth in loans.

In fact, lending is doing well enough that, after drowning in deposits for more than two years, many regional and community banks are now telling analysts that they are running into liquidity problems. The chief operating officer (COO) at a community bank in the northeast told analysts that he could see some of his competitors starting to struggle,

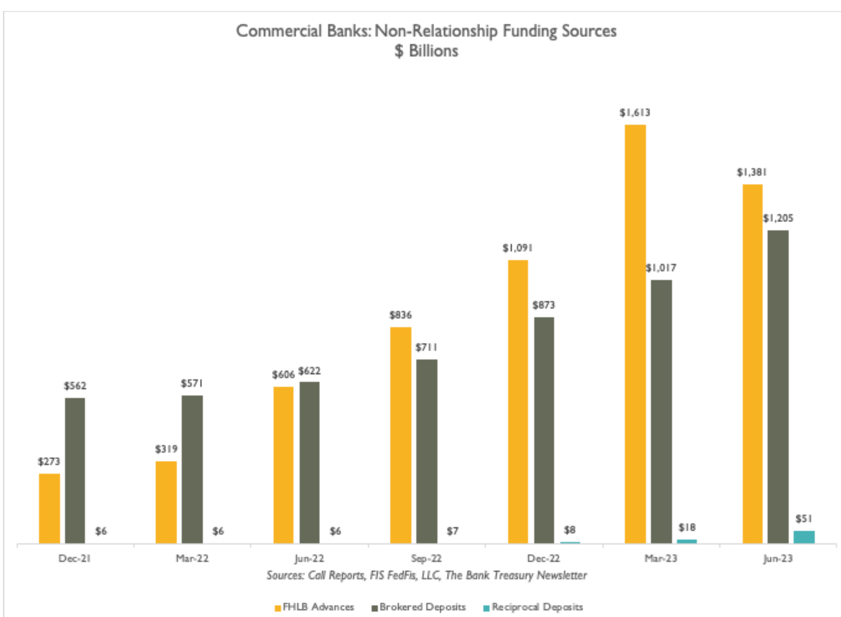
> *"A lot of banks, predominantly smaller ones, have run out of liquidity. They don't have enough funding that they can extend to clients. A few folks are focused on only existing clients…a few are just not lending. "*

In the absence of sufficient deposits, and with a securities portfolio available-for-sale that may be multiple points underwater as this month's chart deck reviews, bank treasurers have two main go-to sources of liquidity. They can draw down on their advance lines with the Federal Home Loan Bank (FHLB) or they can raise funding in the brokered deposit market.

According to bank call report data for Q2 2023, the banking industry initially leaned on advances in Q1 2023 when deposit outflows surged in the immediate wake of the SVB and SBNY failures. In Q2 2023, bank treasurers paid down some of their advances and replaced the funds with brokered deposits, treating the advance funding as a short term solution, and brokered deposit funding as a longer term response to their funding gap.

Reciprocal deposits became a popular funding alternative and increased more than threefold in Q2 2023, but based on the numbers, at $50 billion, it remains a distant third liquidity option for deposit-starved institutions (Figure 2). Also see this month's chart deck (Slides 5 and 6) for more detail on advances and brokered deposits.

Figure 2: Commercial Banks: Non-Relationship Funding



Ultimately, the choice comes down to price. The chairman, president and CEO of a northwestern-based community bank, faced with the choice between secured funding from his FHLB or unsecured funding in the brokered market, saw advances as the better deal. It comes down to cost, as it always does he told analysts,

> *"We have been choosing to utilize borrowings as opposed to broker deposits because of their cost."*

Regional and community banks back in Marcia Stigum's day were deposit rich and loan poor, while the largest banks were the exact opposite. These days those roles are exactly reversed, as the LDR for large banks in the Fed's H.8 series at the end of last month was 62%, compared to 84% for the small banks. Large banks can afford to hold the line on deposit pricing, while smaller institutions often have no choice but to pay up for nonrelationship funding or pay up to keep key relationships. Either way, funding costs are an issue for bank treasurers managing balance sheets of all sizes, but especially so for smaller balance sheets where the menu of funding options is more limited.

Banks of all sizes are seeing a shift in their deposit mix from noninterest to interest bearing, as higher rates force corporate treasurers and individual savers to ration their cash piles more efficiently. The migration from noninterest to interest-bearing is ongoing, and even though demand deposit balances remain plentiful in aggregate, the effect of the migration is already felt by smaller regional and community banks. They are seeing the cost of the migration in their rising funding costs that are squeezing their margins and lowering their profit guidance estimates. The chairman, CEO, and president of a community bank in the Midwest expected that the pain will only end when the Fed stops raising rates, and even then, at these higher rates, the migration might only slow, not stop entirely,

> *"The longer that the Fed raises rates, the more likely that customers will look to reposition cash. If somehow, and we don't really anticipate this, if somehow the Fed has a change of heart and starts to reduce rates, you could see some migration while people try to lock in. And if the Fed announces they're done for the time being, you can also see some migration while people are trying to lock in. So, we're not sure that the story is fully written on deposit interest expense right now…But the longer this environment goes on, the more migration risk there is, obviously…I wouldn't necessarily say that we've seen the last of it or we've seen some kind of peak."*

If the Fed pauses and then stays higher for longer, the CFO and Treasurer of a community bank in the northeast expected pricing pressures to ease, but not disappear entirely,

> *"Even if the Fed pauses…just as we continue to expect to see migration from low or noninterest-bearing deposits into higher-rate certificates, so we continue to expect increases…If the Fed does pause over time, that pressure abates a bit and…the pace at which monies move from low interest-bearing to noninterest-bearing slows a bit. The repricing of the non-maturity deposits perhaps slows a bit, as well."*

Deposit betas will continue to move higher for a couple of quarters after the Fed's last rate hike, according to the CFO of another community bank in the northeast,

> *"I think it's fair to say that 2 quarters after the Fed has put their stake in the ground as we're done, we should probably be getting to the end of the pressure that would come on the funding side."*

When the Fed does finish, it will be a relief for bank treasurers and their AOCI problems that have complicated bank liquidity management, not to mention had a dampening effect on net interest margins (NIM) and net interest income. Even without the AOCI headache, selling bonds for liquidity purposes when rates are high that were bought when rates were low is a losing strategy, and the entire strategy of running of liquidity portfolio of bonds may cost more than it makes in shareholder value.

Bank treasurers will insist that the investment portfolio's primary purpose is as a source of liquidity, and secondly, as a source of income and as a hedge for the balance sheet. But as a source of liquidity, Marcia Stigum concluded,

> *"What banks found was that as loan demand slackened, interest rates would fall sharply, and as loan demand picked up, they would rise sharply. In this environment, using bonds as a source of liquidity meant buying bonds at high prices and selling them at low prices. Thus a bank that viewed its bond portfolio as a source of liquidity found the latter to be an automatic money loser, over times the portfolio provided some interest income, and a lot of capital losses."*

Buying bonds does not pay. But, when rates were at 0%, bank treasurers accepted a flood of deposits and buying bonds was a way to do something to stop the compression this flood caused on NIMs. So, they bought bonds. They bought CMOs, they bought Agency CMBS, and many bank treasurers stepped out on the yield curve in search of yield for their NIMs. The strategy seemed to be a winning one back then. Until it was not. And now they have AOCI problems.

The Fed's Basel 3 Endgame proposal published this month would take away the AOCI opt out option for banks in the regulatory-defined Category III and Category IV, applying the scope down to banks with total assets exceeding $100 billion. Of course, this does not even happen until 2025, so who knows if AOCI will still be an issue by then. Community banks can still opt out of counting AOCI in regulatory capital. Unless faced with a sudden fatal run on deposits and being forced to sell bonds at a loss, AOCI is an accounting issue for most bank treasurers. The franchise value is intact according to the COO of a community bank in the northeast,

> *"There's no change on how we look at our business…A tremendous amount of…economic value to our shareholders is not captured on the balance sheet…We're focused on regulatory ratios…Our regulatory ratios remain very strong. They continue to increase…So capital is growing at a very robust pace. We have not been able to deploy it through merger and acquisitions (M&A). So, we just keep accruing it to our company."*

He may be able to ignore AOCI for his own balance sheet, but as he went on during his call with analysts earlier this month, right now accounting would be one of the main obstacles to his bank-acquisitive ambitions. There had been a slight uptick in M&A activity recently, he said, but a lot of problems need to be addressed to get a deal done,

> *"I think there is a…slight uptick of sellers being more willing to engage in discussions. I think the challenges there remain the same…you've got a lot of unknowns as to what the balance sheet looks like, what the margin looks like. I think this cycle is showcasing that some balance sheets can change quite drastically in the matter of a couple of quarters…I think the second challenge is there's not a lot of capital left once you mark the balance sheet. So we have to essentially pay for the deal twice….It's also hard to figure out in today's environment when you announce a transaction what does that does to the deposit base, given that it's like sounding the starting signal for all the competitors and high-rate customers to start looking around yet again….And then the last piece is the uncertainty as to the timing of closure of transactions these days. Clearly, there's a higher hurdle in terms of unknowns that come with a transaction from all the regulatory bodies."*

An entire generation of bank treasurers and their team members have grown up with interest rates that have trended at or near 0%. They have no experience with interest rates as high as they are today. Yet, even with the Fed Funds target range at 5.25%-5.50%, there really is no comparison with a Fed Funds rate that topped out at over 21% back in Marcia Stigum's day. Times have changed, this time is different, and there really is not much practical information that the 40-year old edition of her book can teach a bank treasurer in 2023. True confession. Your editor-in-chief's copy was just gathering dust on a bookshelf, unread for decades, until he decided to thumb threw it again for this month's newsletter.

But the book is a good read and well-worth a good page-thumb, even if it is not available to be read on an Apple I-Pad. There is much that her book talks about that has not changed, and her insights are timeless. The front-end of the yield curve still wags the rest of the fixed income market, and money market funds vie with banks for the public's savings. The Fed is the market's most watched player, then as now. Bank treasurers are still watching.

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