# The Bank Treasury Newsletter

The newsletter is once again an independent publication. We will continue to bring our readers monthly updates on developments in the bank treasury space. The editors thank our subscribers for their support and look forward to continuing the dialogue with them in this space.

This has been another eventful month in bank treasury, and it is not over yet. On May 1st, First Republic Bank (FRB) became the third bank to fail this year, since Silvergate Bank announced that it was liquidating its bank on March 8th, joining Silicon Valley Bank (SVB) which failed on March 10th and Signature Bank, New York (SBNY) which failed on March 12th. Before these three banks failed this year, the previous bank failure was in 2020, when Alamena State Bank failed, a $2.7 million bank in Kansas. According to the FDIC, since the year 2000, a total of 566 banks have failed, but SVB and FRB are the largest banks to ever fail, eclipsing Washington Mutual (WaMu) which failed in 2008. The FDIC proposed to expand insurance coverage and inclined to transaction accounts on an unlimited basis.

On May 11th, the FDIC released an estimate saying that the failure of SVB and SBNY will cost the Deposit Insurance Fund (DIF), with a balance of $128 billion, $16 billion, which it plans to recover through a special assessment to be charged to all banks with total assets over $5 billion. Banks with total assets over $50 billion will cover 95% of the cost. This assessment is on top another special assessment the industry is currently paying to raise the DIF back to 1.35% of insured deposits by 2028 with the surge of insured deposits after the on-set of Covid. According to bank call reports, at the end of March 2023, uninsured deposits in aggregate equaled $11.9 trillion, down from $13.0 trillion at the end of March 2022 (5% of the beginning balance), and down from $12.6 trillion at the end of December 2022. These deposit outflows appear to have gone into T-Bills and money market funds. Insured deposits equaled $9.4 trillion at the end of March 2023. Bank treasurers report seeing increasing competition in consumer deposits, especially now that the Fed crossed 5% Fed funds with its 25-basis point hike on May 3rd.

The review of what went wrong is on-going. Held-to-maturity (HTM) has been singled out and bank supervisors say that they will be rethinking the key metrics they use to assess a bank's liquidity risk, as the traditional metrics used today, including mainstays such as "core deposits," suggested that the liquidity at the failed banks was no worse than adequate pretty much up until the day the banks had failed. The ability of rating agencies to adequately assess the credit risk of a bank is certainly called into question given that they maintained their investment grade ratings on SVB and SBNY right up until they failed. Bank treasurers widely expect that they will carry more cash on the balance sheet to cover funding from uninsured deposits, with significant ramifications for Asset-Liability Management (ALM) practices. The Fed and the FDIC blamed bad management at the failed banks but also conceded their own failures to supervise properly these institutions which they blamed on organizational mindset and resource constraints. Indeed, the FDIC, which was SBNY's primary bank supervisor, complained that its targeted examination teams to cover SBNY could not be staffed adequately because of resource constraints. Nevertheless, both agencies noted that the proximate cause of the bank failures was a massive run on the banks sparked by concerns about them on social media and aided by the ability of depositors to withdraw money instantaneously through digital channels. The failure of FRB sparked more sell offs in the stocks of several publicly traded regional banks, undermining confidence in these institutions, and raised their risk of failure, too.

Bank treasurers say that the inverted yield curve remains a chief concern for delivering net interest income this year, and competing for deposits, as their marginal cost of funding over 5% precludes their paying up, and loans priced off the 5-year part of the curve do not offer a sufficient return. The risk that the Fed cuts rates this year adds to their anxiety.

# BANK TREASURERS UNCHAINED

Dear Bank Treasury Subscribers,

We live in an age of perpetual disruption, and everything is disrupted. Geopolitics, domestic politics, healthcare, banking, travel, employment, on and on. The list of just about anything and everything you can think of has been disrupted at one point or another. Things are always getting disrupted, the old replaced by the new, and then the "new" is replaced by the new "new."

Disruption can be a good thing, unleashing creative impulses that might have never been explored if not for a proverbial "kick in the pants." We can all occasionally use that kick, bump, or shove out our comfort zones, whatever you want to call it. Nothing ever stays the same, and that is a good thing. We need occasional disruption in our lives, because as the singer Kelly Clarkson says, whatever doesn't kill us makes us stronger. If nothing else, complacency breeds without it. Thus, the newsletter is going through a little bit of its own disruption this month, as its editor-in-chief and staff writers suddenly find themselves back on an independent platform. The team is once again in our old Bank Treasury Newsletter offices, getting new building passes, pulling off furniture dust cloths, and turning back on the lights and computers last used when people were still using the I-Phone 7.

Nevertheless, rest assured, even while our search committee seeks out the support of a new owner for the newsletter, our editors are still in it, still involved, and still engaged. We remain as committed as ever to continue our reporting on the goings on and the latest thinking in the fast-moving world of bank treasury. In fact, the timing of our newfound independence for however long it will continue could not be better. Because it is right now, after the failure of Silicon SVB, SBNY, and FRB, with investor confidence in the regional and community bank model shaken, while the dust is still settling and the blame game just beginning, and as the "lessons learned" are still getting drawn, to confront some hard, blunt truths. And what better position to offer them than on an independent platform like ours.

Because the truth is that everyone, bank treasurers, CFOs, CEOs, investors, regulators, politicians, the Fed, the business media, social media, accounting rules, crypto, and yes, the issuer-pay rating agencies, all have a role to play in the failure of these three banks. It is also true that none of them are to blame, that even if management at each of the banks were five stars, nothing could have saved the banks from failure given the catastrophic deposit outflows they suffered. But even so, nothing excuses bad management practice. As the FDIC wrote in its post-mortem on SBNY on April 28th,

> *"The primary cause of SBNY's failure was illiquidity precipitated by contagion effects in the wake of the announced self-liquidation of Silvergate Bank… on March 8, 2023, and the failure of SVB on March 10, 2023, after both experienced deposit runs. However, the root cause of SBNY's failure was poor management."*

These banks were in the wrong place at the wrong time. But it was because management was so bad, so full of themselves that they knew what they were doing when they really did not, that they were especially vulnerable to a run and woefully unprepared for a crisis. Their behavior was unforgiveable, clueless, reckless, and whatever else they deserve to be called. If nothing else, they met the standard for getting their bonus checks clawed back.

The banks probably would have failed anyway, but SBNY management were the master of unforced errors. Who talks to bank examiners the way SBNY management talked, as described by the FDIC later in its report?

*"When the FDIC raised concerns about the deposit concentrations, SBNY management did not heed the FDIC's concerns and responded that the close relationship that SBNY cultivated with these large depositor clients made them less likely to leave SBNY. When examiners presented a white paper about the risks of maintaining high levels of uninsured deposits as it related to the failures of Washington Mutual Bank and IndyMac Bank in 2008, SBNY management emphasized how different its bank's profile was from those two banks as they were failing. "*

The Fed came to roughly the same conclusion about SVB, writing,

*"Significant risks were treated by SVB Financial Group (SVBFG) more as a process to fix than as a clear and present threat to the viability of a firm."*

Note to bank treasurers: Never ever tell an examiner that your bank is not like SVB, SBNY, or FRB, or for that matter WaMu and IndyMac, because you know your customer. Never show bank examiners you are trying to check a box. Those banks were unicorns for a lot of reasons. Yet, even if you do not make rate bets using accounting "tricks," your growth has been steady, you do not go after crypto deposits, and you do not have a large dependence on uninsured deposits, it would be a mistake to conclude that there is not some element of SVB, SBNY, and FRB in all of us.

And, if you do want to dismiss bank examiner concerns, brush them off, at least make sure that you have done your homework. As the FDIC report continued,

*"Notwithstanding the inherent riskiness of the bank's funding structure, management expressed its belief that the deposit base was largely stable based on its client-centric business model. Large depositors typically also maintained their operating account and/or lending relationship with the bank and it was therefore assumed their deposits were "sticky"—that is, unlikely to move. However, SBNY never fully developed liquidity stress testing deposit assumptions or a deposit runoff framework to substantiate this assumption. SBNY management should have gathered applicable industry and bank-specific uninsured deposits data that could have been used to model the potential degree of uninsured deposit volatility during adverse liquidity events."*

Inexcusable.

But do you want some more truths, dear reader? HTM is not the villain in the story no matter how much the business media has tried to finger it as such. No bank failed because it had socked away risky rate bets and hid them in an accounting loophole, some wormhole where mark-to-market (MTM) and negative solvency ratios do not matter. Crypto hysteria compounded by regional bank hysteria caused the three banks to fail, four if we include Silvergate, which technically did not fail. Full stop.

You know why HTM accounting is blameless in the tragic drama? Because the average large uninsured depositor in SVB running out the door on the night of March 9th and the uninsured depositor who was so worried about SBNY on Sunday March 12th in the afternoon, right in the middle of the NCAA game, that they just had to withdraw every penny of their money before the Oscars had even started, were not bank analysts and frankly probably never heard of HTM before that week. They also never paid much attention to their bank's deposit mix, or underwater bond portfolios. They had heard of crypto and were very digital, that is for sure.

Look, almost every bank treasurer in the country, even the ones who insisted that the use of the HTM account, was against everything they believed in as stewards of their bank's liquidity, booked bonds there in 2022 as the Fed was raising rates. The largest banks that are required to count the mark-to-market on the bonds held in their available-for-sale (AFS) portfolio in regulatory capital, and the smaller banks that were allowed to check the "opt-out" box on their call reports, both groups moved bonds into HTM.

HTM was the way to go, a smart move, a way for bank treasurers to protect Generally Accepted Accounting Principles (GAAP) tangible common equity (TCE) from what has always been regarded by bank management and bank analysts as lop-sided accounting, only valuing the assets at market but not the liabilities, also known as (aka), the deposits. Last fall, after Q3 2022 results revealed that the industry had huge negative Accumulated Other Comprehensive Income (AOCI) losses on their balance sheets causing TCE ratios for some banks to fall dangerously close to 0% or worse, it was the banks that had not moved bonds into HTM that year, or not moved enough, that had some explaining, some defending to do, why their suddenly reduced TCE ratios were not a concern.

The fair value of deposits is not a thing under GAAP given the free option depositors have, to withdraw deposits at par immediately on demand. That was usually just a theoretical risk and antithetical to modern fractional reserve banking dating back to the 18th century, that says that that theoretical risk could never happen. Depositors do not just show up on Sunday and withdraw everything all at once. Now, for once, a stupid lop-sided accounting rule might not be so stupid after all.

Every bank treasurer did it. According to call report data, the four largest banks reported that 70% of their securities were booked in HTM by March 2023. The super-regional banks with total assets over $100 billion, so-called Category III and IV banks, had 38% of their bond portfolio in HTM, up from 24% a year ago, and even smaller regional banks below $100 billion increased their allocation to HTM to protect their TCE from negative AOCI.

It is just plain revisionist history to suggest otherwise. Every bank in the country had a bond portfolio primarily comprised of mortgage-backed securities (MBS) with a previous duration of 4-5 years which, thanks to the Fed's rate hikes, extended to 6-7 years. The only question is whether a bank treasurer was brave enough to keep the portfolio in AFS or was not and put some of it into HTM. A year ago, deposits still seemed very sticky, the perfect funding base to support a long-term asset like HTM. Then suddenly, they were not, and HTM was no safe harbor from GAAP and MTM. As the president and CEO of a regional broker-dealer testified to Congress this month, the Fed raised rates, and raised them, and raised them,

> *"The recently failed banks had concentrations that made depositors nervous and HTM Accounting was not a safe harbor during a period of record Fed tightening. In hindsight, it appears that interest rate exposure is what made Silicon Valley and First Republic riskier in the eyes of depositors. Both banks grew at fast speeds during the pandemic and used the COVID deposit surge to invest in long-dated fixed rate assets, creating a significant duration mismatch on their respective balance sheets.*

Capping HTM was one the proposals he went on to mention to the assembled elected representatives on the House Financial Services Subcommittee on Financial Institutions and Monetary Policy,

> *"Suggestions for the future include modifying rules surrounding HTM securities and placing limits for the use of this accounting treatment as a percentage of bank capital. Or, building in circuit breakers if exposures exceed certain thresholds. Even without regulatory action on this point, I expect market forces to require a greater accounting of concentration in a bank's core business and more limited use of HTM accounting."*

Let's get this straight. There is no HTM accounting. There is mark-to-market MTM accounting for the investment portfolio, the old accounting mainstay for 30 years called Statement of Financial Accounting Standard, No. 115 (SFAS 115), which divides a bank's bond portfolio into three components: a trading book which is subject to full MTM, with unrealized gains and losses recorded daily through the income statement, a HTM portfolio, which is carried at cost, and an AFS portfolio which is carried at cost but with unrealized gains and losses recorded as an adjustment to the equity account.

Unlike with HTM, a bank treasurer can theoretically sell bonds from AFS to fund deposit outflows, but in practice, bond portfolios that were as deeply underwater as they were last October could not be sold regardless of whether they were booked in HTM or AFS without harming regulatory capital. SVB certainly found out the hard way what happens when you make a public announcement about taking a $2 billion loss for selling the AFS book on one fine Wednesday afternoon in March. The window to get out of holding underwater bonds in AFS slammed shut in March 2022, which was exactly when banks were buying bonds and booking them in HTM.

We also do not need circuit breakers or any limits on HTM use, whether regulatory, or market directed. Because if HTM is a problem, there is a much bigger account on bank balance sheets that is carried at cost to contend with, called the loan portfolio. Bottom line, if banks cannot count on their ability to fund long term assets because they have to worry about the extreme tail risk that a deposit that usually has a 25% repricing beta profile suddenly jumps to 100% beta, then the industry is in more serious trouble than what could be fixed by changing accounting rules on bond investments. Interest rate and liquidity risk does not know from accounting rules when they bite.

For that matter, talking about extreme-tail events, if the U.S. Treasury defaults next month, uninsured depositors and new users of Treasurydirect.gov to buy T-Bills will not be the only ones in trouble.

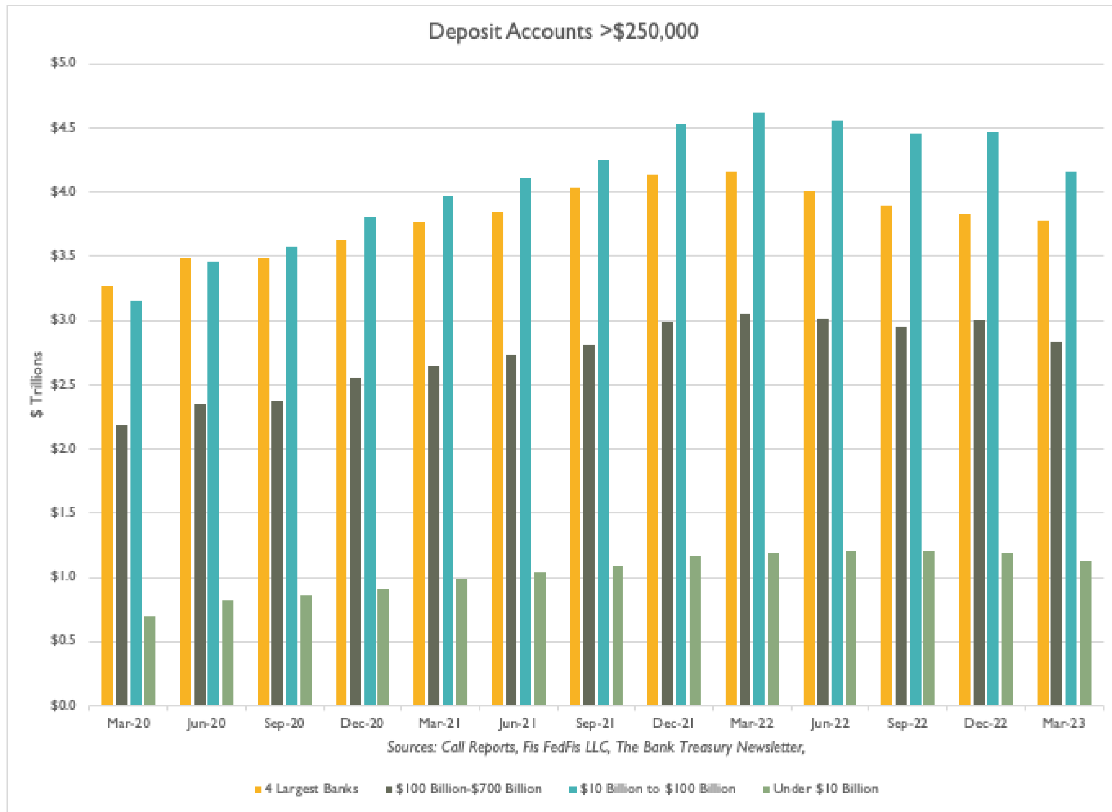
Besides, regulators already have a capital charge for interest rate risk. It is called the Tier 1 Leverage ratio, or if your bank is below $10 billion, the Community Bank Leverage Ratio (CBLR), which is the same thing. The leverage ratio requires banks to hold capital in proportion to their total assets, whether these assets are AAA-rated bonds or in risky loans, whether bonds are held in HTM or AFS. In 1993, with the implementation of Basel 1 risk-based capital rules behind them, regulators decided to retain the leverage along with the new Tier 1 and total risk-based capital requirements as the capital metrics defining Prompt Corrective Action and the threshold for well-capitalized.

Back in 1993, regulators were already working on Basel 2 with the ink barely dry on Basel 1, expecting to come up with a capital charge for interest rate risk with the next iteration, but even by Basel 3, and even since then, in the present deliberations around Basel 4, coming up with an explicit capital charge for interest rate risk has not gotten very far. The leverage ratio is really what we got and what we are stuck with in lieu of a better alternative that has not come about in 30 years.

Every sized bank experienced a surge in uninsured deposits from March 2020 through March 2022. In aggregate, uninsured deposits increased by $3.7 trillion, to $13.0 trillion as the Fed expanded its balance sheet with quantitative easing (QE), and then in the last year they receded by $1.1 trillion. Running off a little faster than what they perhaps expected last year, $0.6 trillion of the run-off was just in the last quarter. This still leaves the industry with a significant chunk of the initial Covid surge, but that is not the way most nervous bank treasurers are thinking about it.

You do not have to look at their faces, you can see it in their numbers. In Figure 1, uninsured deposits, defined as deposits with a balance over $250,000 excluding retirement accounts, are divided into four peer groups, based on asset size: the four largest banks, and banks with total assets between $100 billion to $700 billion, $10 billion to $100 billion, and all other banks below $10 billion. As shown, uninsured deposits fell from December 2022 to March 2023 by $586 billion. Of that amount, $301 billion came out of banks with total assets between $10 billion to $100 billion. Banks with total assets between $100 billion and $700 billion accounted for the second largest outflow, equal to $165 billion.

**Figure 1: Uninsured ($250K+ excluding Retirement Accounts)**




On average, 5% of the balance of uninsured deposits left the banking system in Q1 2023. The Paycheck Protection Program (PPP) fueled a lot of the growth surge, especially at regional and community banks, as businesses let disbursements sit in their checking accounts serving as a cash cushion. But now that businesses are spending down their PPP balances, they are probably helping to fuel some of this outflow, especially at these institutions.

But for the record, not every bank that filed a call report for Q1 2023 reported a net loss of uninsured deposits from year-end 2022. Out of 127 banks with total assets between $10 billion to $100 billion, for example, 20 reported that their uninsured deposits increased by an average of 7% from their year-end 2022 balance. A third of the banks with assets below $10 billion reported that uninsured deposits on average increased by 9% in Q1 2023, over their year-end balance.

Where did it go? Individuals pulling cash out of deposit accounts and setting up accounts at Treasurydirect.gov could account for a large chunk of the outflow. The data is not available yet for Q1 2023, but from the end of March 2022 through December 2022, individual holdings of Treasury securities increased by $700 billion, according to the most recent Flow of Funds report. But we also know, according to data compiled by the Office of Financial Research through March 2023, that $400 billion flowed into money market funds just in March. So apparently, despite repeatedly stated worries by Fed officials about a potential run on the money market funds, and despite the history of the banking industry serving the public as a flight to safety, in the wake of the failure of SVB and SBNY, even before registering the subsequent failure of RFB this month, the money market funds became a flight to safety shelter against the banking industry.

Uninsured depositors suddenly pulling their money out of the bank and ineptitude are primarily to blame for the bank failures, but so is social media and business media. The stock market is to blame. Financial disclosures are to blame.

Analysts and the investors who they represent demanding in March 2022 why bank management were not deploying more of the excess deposits they had into bonds with the 10-year Treasury over 3% and MBS at plus 5%, are to blame. Analysts not seeing any problem with negative AOCI until it was too late are to blame.

The problem is that it is not enough for bank treasurers to just focus on the fundamentals. At least not the traditional ones. Liquidity cannot really be captured through balance sheet metrics. As the Fed concluded in its report on SVB,

> *"Moreover, the standard liquidity risk metrics in the Regional Banking Organization (RBO) portfolio were likely not appropriate for a bank like SVB. For example, a commonly used metric was the ratio of core deposits, which excludes large time deposits and brokered deposits, to total assets. By this metric, SVB appeared to have a comparatively stable source of funding despite the fact that SVB's deposits were concentrated in large, uninsured accounts that proved to be quite volatile."*

Bank treasurers cannot take comfort in their peer comparisons, relying on them at their peril, and even satisfying Basel III Liquidity Coverage Ratio (LCR) does not tell you much about a bank's true liquidity,

> *"Supervisors primarily relied on the comparatively large percentage of the balance sheet held in cash reserves and investment securities, and SVBFG's estimated coverage relative to the U.S. LCR reduced requirements as drivers of the favorable liquidity position assessment…On the surface, SVBFG's liquidity risk appeared to be substantially mitigated by its growing deposit base and a large proportion of assets invested in low-credit risk securities. In the case of SVBFG, these regulatory reporting metrics and the firm's risk reporting were not suitable for assessing the risk profile of the specific deposit base.*

Regulators are to blame. As an investing sage based in the Midwest explained to a reporter this month, he would be reluctant to buy a bank in this environment because,

> *"The incentives in bank regulation are so messed up and so many people have an interest in having them messed up -- it's totally crazy…So we are very cautious in a situation like that about ownership."*

Of course, part of the problem is that there are not enough resources to supervise the industry, especially the largest institutions. As the FDIC wrote,

> *"The FDIC experienced resource challenges with examination staff that affected the timeliness and quality of SBNY examinations. From 2017 to 2023, the FDIC was not able to adequately staff an examination team dedicated to SBNY. Certain targeted reviews were not completed timely or at all because of resource shortages. "*

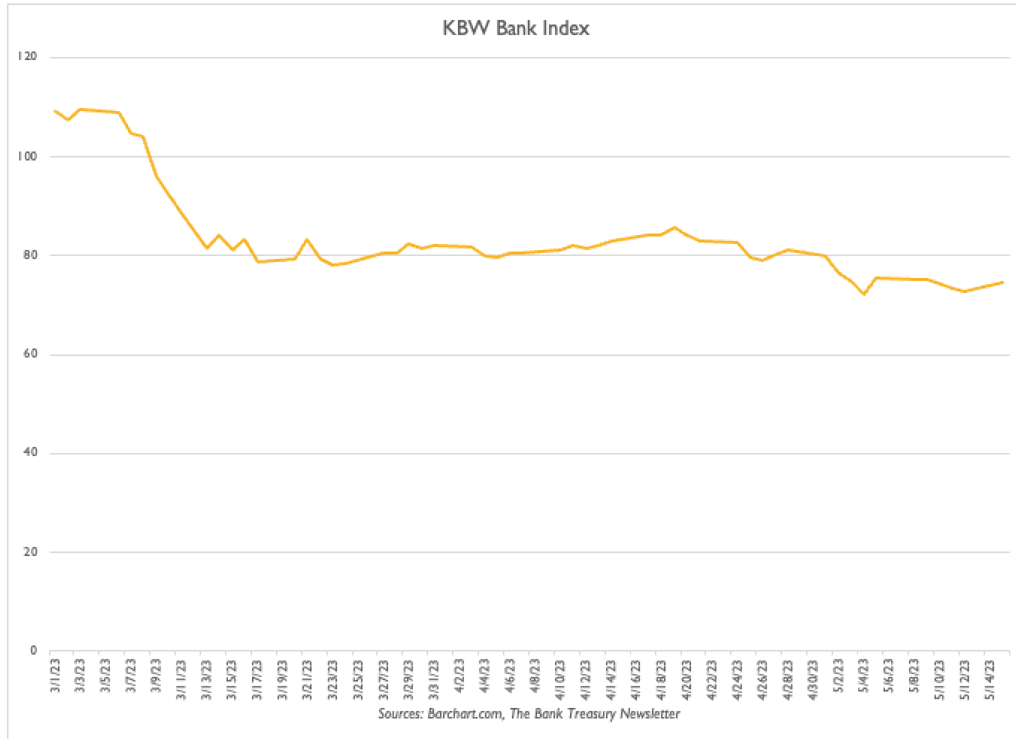
Rating agencies are to blame. Who can be forgiven for what in hindsight seems so ridiculous, and who would trust in ratings offered by any agency, especially one that went out of its way to praise SBNY's liquidity management when it affirmed its highest investment grade rating in its bank rated universe last December 2022, writing in its update that,

> *"Signature's ratings continue to be supported by a comparatively strong leadership team with extensive experience and long tenure at the bank. Executive management acumen is underpinned by a comprehensive risk management regime, particularly in credit and liquidity risk management."*

But bank treasurers look at more than fundamental liquidity measures. Changes in their bank's stock price matters, too. And even if their own bank is not publicly traded, their bank's large investors and depositors see other regional banks in trouble and need reassurance that their money they have there that they have not already withdrawn is still safe. Bank treasurers plan to increase their outreach to large depositors continuing to emphasize the differences between the banks

that failed and their own. But stock price trends can be unsettling as regional bank stocks continue to bounce along the bottom of their 12-month range, having lost more than a third of their value since last March (Figure 2).

**Figure 2: KBW Bank Index**




The question remains, could the stock market bring down a bank that was fundamentally sound. Of course, there is no bank, no matter how sound, that is not vulnerable to a deposit run, but usually that starts because the bank reports a large loss. But, according to the CEO and chairman of a large regional bank in the northeast speaking at an industry conference this month, the chance that a concerted stock market short could cause a run and bring down a bank remains an open question. It has not happened yet,

> *"The bigger banks that failed had a very unique business model, they grew too fast, and growth exceeded management's capacity to actually run the place in a safe and sound fashion. And if you look around, there's not many more examples of that…So, I think that it's not a regional bank crisis to me…Whether the shorts can bring down a bank that appears to be sound, remains to be seen. I think that's kind of the wildcard that I would see out there."*

And this is how it would happen, he went on to explain,

> *"I do think there's another wild card out there is that the shorts have really piled into the regional bank space. And one of my concerns is -- and other CEOs, not just me, is it seems like a perfect short because if the whole group is a little wobbly, and they start trying to drive the stock price down, stock price can be connected to deposit outflows. So some banks running itself fine, but then a depositor sees the stock price goes down and says, "I wonder if my money is safe, maybe I should diversify then the bank reports deposit outflows and the whole vicious cycle kicks in."*

SVB, SBNY, and FRB constitute a big wake-up call for bank treasurers, demanding that they reexamine and test core assumptions they have used in deposit modeling, and interest rate and liquidity management. A common observation by the Fed and the FDIC in their post-mortems on the bank failures is that management never saw it coming, right up until

the last minute. Be prepared for all scenarios is what bank treasurers repeat in their sleep. So, maybe those deposits are not as sticky or as stable, maybe depositors, like airline passengers, maybe they really do have a choice where they keep their money, and maybe balance sheets are not so asset sensitive.

To quote the Fed in its SVB post-mortem,

> *"The combination of social media, a highly networked and concentrated depositor base, and technology may have fundamentally changed the speed of bank runs. Social media enabled depositors to instantly spread concerns about a bank run, and technology enabled immediate withdrawals of funding."*

Regardless of what bank treasurers think of their business models, bank examiners will probably not be as deferential going forward. Business models reliant of growing uninsured deposits will need rethinking, liquidity stress testing will need revising, and earnings expectations will need reimagining. Assets and liabilities will need restructuring and remixing. Because here is a very tough message. The ability of the banking industry to deliver shareholder value, however poorly it has done this in the past, is going to get poorer, or to quote the chairman and CEO of one of the largest banks in the country speaking this month to a Bloomberg reporter,

> *"I think it's going to get worse for banks — more regulations, more rules and more requirements."*

The CEO and chairman of a large regional bank in the northeast, a category IV bank with total assets between $100 billion and $250 billion, was worried about what regulators might do to tighten the LCR requirements, telling analysts,

> *"A big question is if they start to change the frameworks and the outflow assumptions and force banks in our category to hold more liquidity. That means we have less room on the balance sheet to make loans which has lots of second-order consequences who's going to pick up the slack. Does that move to the nonbank sector? Or is there just less credit available in the country? And what's the impact on the economy? So, these are the kind of debates that are taking place. There are no free lunches in any of this. So, if the decision is that you've got a be more bulletproof from these deposit runs then you're making less loans and that changes the business model…So, to me, that's the one that we're most focused on. I think, the capital stuff is manageable, particularly for us, but we'll see how it plays out."*

Nothing is free. The lessons learned will cost money. Dynamic ALM will incorporate behavioral science into scenario analysis, leverage the thinking power of artificial intelligence and machine learning to optimize balance sheet strategy in these uncertain times. That does not come cheap.

And after that investment of time and lost shareholder returns, bank treasurers will probably just have to sit on more cash to cover more stressful liquidity stress tests. They will need courage to deliver hard truths to the senior executive team and the board expecting to hear a plan how the bank will be able to maintain revenue growth if net interest margins (NIMs) begin to narrow later this year, not strategies that involve assuming higher deposit betas, shorter deposit duration, and less shareholder returns through rate cycles going forward.

They are going to need to defend carrying more liquidity, maybe shrinking the balance sheet, rethinking business plans, and not extending as many loans. When your marginal cost of funding is over 5% and the 5-year Treasury is 175 basis points lower than the 3-month T-Bill, it is kind of hard to fund assets that are accretive to margin, even if you can finagle the borrower to pay a rate with a 6-handle.

Even without regulatory prodding, prudence requires carrying more liquid lower yielding assets, which will be on top of the negative NIM realities. Why do bank treasurers need to carry more liquidity? As the CFO of a large regional bank in the Midwest explained to analysts at a conference this month, he was content to sit on more cash,

> *"Do we need it? I think the reality is we probably don't. It's probably well more than we need, but the reality is that it's always better to have just robust sources of liquidity, and that's what we try to ensure that we have."*

And this is the reason why, the above-quoted CFO from the Midwest-based bank told analysts. Because the bank treasurer's number one deliverable to bank shareholders is to reduce the cost of a range of outcomes, even the extreme tails. But prudence does not preclude bank treasurers from still finding ways to optimize, as the same CFO continued,

> *"The goal of our balance sheet management program is to blunt the range of outcomes, reduce volatility…Protect capital against up-rate scenarios…in the short term. Over the longer term, the prevailing risk is down rates, and so protecting that with a very sizable down rate hedging program…It's difficult incrementally now to add to down rate hedge protection given the inverted yield curve…But it is possible to optimize what that hedge protection cost is relative to the value of it. In the first quarter, for example, we terminated some of our received fixed swaps and replaced them with floor spreads that provide a very similar level of protection, but with lower upfront funding costs."*

Bank treasurers worry how they will afford to pay more for deposits, but a lot has changed in recent months as their terminal Fed Funds rate expectations keep edging higher and even their sleepiest depositors are up and paying attention. Maybe the economic argument is that they should keep letting those depositors walk, let the balance sheet shrink. But no. Keeping those depositors happy is a priority, as the CFO of a regional bank in the southeast told analysts,

> *"I expect us to perform with the industry. Last year, we were allowing the deposit runoff as our peers were competing for deposits at a really high rate. I expect us to be in line with our peer group now while we were intentionally not in line last year…We are getting more competitive on rate. We are doing new-to-bank offers deepening relationships. Last year, we were really protecting our margin by pricing up existing clients, but not being at the top of the range there from that acquisition standpoint.*

Of course, walking a fine line between placating shareholder demand for short-term profits over long-term economic interests comes with the job title of bank treasurer. A lot of work lies ahead, from needing to rethink old assumptions and rejiggering deposit pricing models, to finding ways to optimize balance sheets against a range of uncertainties and up/down rate scenarios, among which now is the risk that a sleepy low beta depositor suddenly wakes up and goes 100% beta overnight or on a Sunday afternoon. There will be more stringent regulations as regulators and politicians try to show the public that never again will banks fail, which of course they will. Overnight, the world looks like a different place. But that is a good thing. Change is good. To quote the Fed report once more,

> *"We need to guard against complacency."*

At the newsletter, we are looking at the new ownership arrangement as a great opportunity to dialogue with our subscribers and keep them in the loop with the latest thinking and concerns among bank treasurers. Out with the old and in with the new. The team is excited to start fresh, and if nothing else, they are looking forward to getting a new computer.

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