WHITE PAPER

CAUGHT BETWEEN LEAKING DEPOSITS AND UNREALIZED LOSSES

A look at the past, the present and necessary steps for reviewing your deposit books and bond portfolios

THE BACK STORY

Pre-pandemic, availability and the cost of funding were the greatest challenges for financial institutions. financial institutions had to increase the rate on deposits and their dependency on wholesale funding. Total deposits (checking accounts + money market deposits + CDs + savings) increased 4.7% in the U.S. in 2019.

The pandemic brought in a rush of deposits. These could be traced mainly to distribution of federal stimulus and a slowdown in spending. Total deposits increased by more than 20% in 2020. Then from September 2021 onward, deposits growth slowed and spending resumed. However, financial institutions continued to have large reserves of low-cost funding.

Loan demand has not kept up with the deposit influx. Industry-wise, the LTD ratio fell from 80% at the end of 2019 to 63% by mid-2021. For community financial institutions, it fell from 85% to 74%. That induced financial institutions to find other forms of riskier investments to deploy their extra liquidity. This can be precarious due to the uncertain economic environment and a lack of expertise in smaller financial institutions.

Deposit betas (the measure of repricing sensitivity for an increase in funding costs) are rising. This poses a risk for smaller financial institutions, in contrast to the largest financial institutions with a national reach, who traditionally benefit from significant customer inertia, large volumes of depositors and many dormant savings and checking accounts.

The result

The surplus of cheap retail funding over the last 24 months has led to financial institutions investing in securities for yield enhancement that may be held to maturity. The rise in rates has pushed bond portfolios deeply underwater, sparking concerns that financial institutions would need to sell these bonds at a loss to meet liquidity needs if a crisis unfolded.

Many financial institutions have systematically moved from available for sale (AFS) to held to maturity (HTM), however the accounting is different, as is the regulatory treatment.

There is a risk of the HTM securities being out of money and if these securities have to be sold in extended market crisis, and at a loss, then that will trigger both a P&L impact and capital deduction. Regulators are likely to focus on stress testing these HTM securities for extreme events, where the sale is forced due to an external market-wide or firm-level event.

"Furthermore, higher market interest rates have led to continued growth in unrealized losses in the banking industry's securities portfolios. These will be matters of ongoing supervisory attention by the FDIC."[1]

Martin Gruenberg – FDIC Chairman

[1] *Source: FDIC*

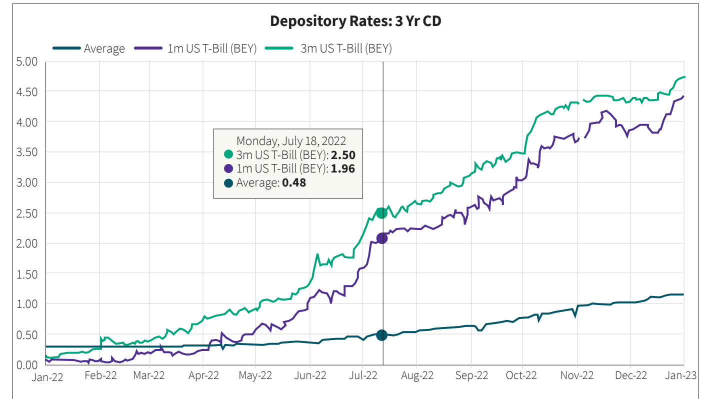
Present state of the deposit market

Since the Fed started to hike interest rates at the end of Q1 2022, the gap between what financial institutions charge for loans and deposits rates have never been so wide. At the same time, deposit growth has outpaced loans by more than $4.5 trillion since the end of 2019. A considerable amount of these funds was allocated into the bond market.

By the first quarter of 2022, U.S. financial institutions and savings and loans associations that file GAAP financial reported $64.14 billion in unrealized losses, down from $4.9 billion in the prior quarters.

Deposit costs increased more notably by end of Q3 2022 due to the Federal Reserve's rate hikes. Money woke up and began searching for higher yield alternatives, such as U.S. treasuries and money market opportunities. So far, financial institutions have been okay with these outflows as they were sitting on cash with record low-levels of loan-to-deposit ratios. This dynamic will likely change soon. Financial institutions will try to mitigate these outflows by increasing their deposit rates.

Large traditional national financial institutions do have a benefit of significant customer inertia in their deposit base that helps duration, and they tend to be more rate insensitive.



> **"Recent events should now impress on boards and ALCO members how truly important investing in ALM is, not just in terms of human capital, but also improving ALM systems to fully evaluate those financial risks that can really hurt."**
>
> **David Hough, Senior Advisor, Balance Sheet Management, FIS**

This doesn't necessarily hold true for smaller, niche and regional depository institutions, who do not have whole market reach and geographical presence, or for pure digital financial institutions who play to a particular niche.

All things considered, deposit betas are rising as customers in these challenging times wake up to the potential of earning more than a few basis points on their savings and firms now need to work to protect their deposit franchise.

A key to understanding where your deposit growth has come from over the last 24 months – is it new accounts? Or an enlargement of deposits from your existing customers? Assess how sticky and rate sensitive those pools could be, whether consumer or business deposits as that mix is what is going to affect your deposit beta.

> **"Still, some banks have maintained that it's too early to say what cumulative betas will be this time, but JPMorgan Chase called deposit pricing a "wildcard" in December 2022."**[2]

> **"Being a risk manager is about so much more than filing regulatory reports and achieving check-box compliance. The real ask is to be imaginative – to look where might problems lie and proactively test them in a sandbox before they become an actual (and critical) problem."**
>
> **Joe Sass, senior vice president, Risk and Performance, FIS**

[2]Source: S&P Global

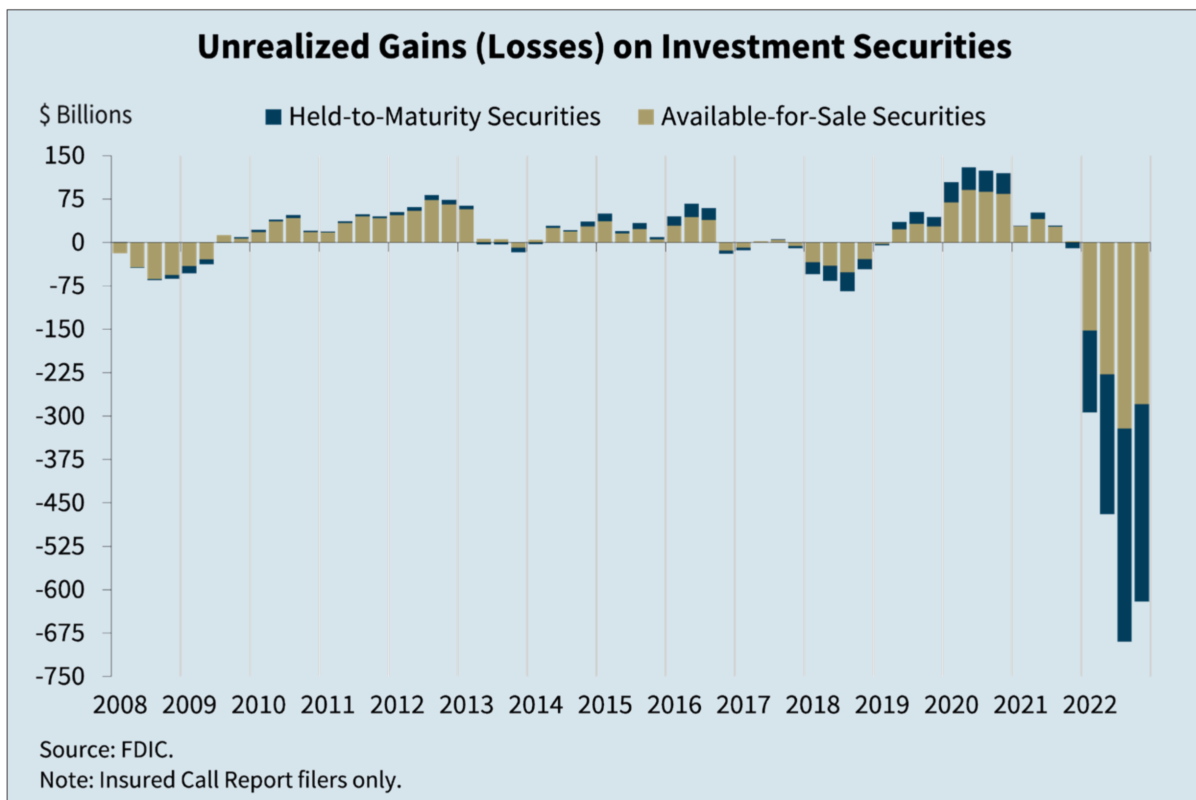
The hidden cost

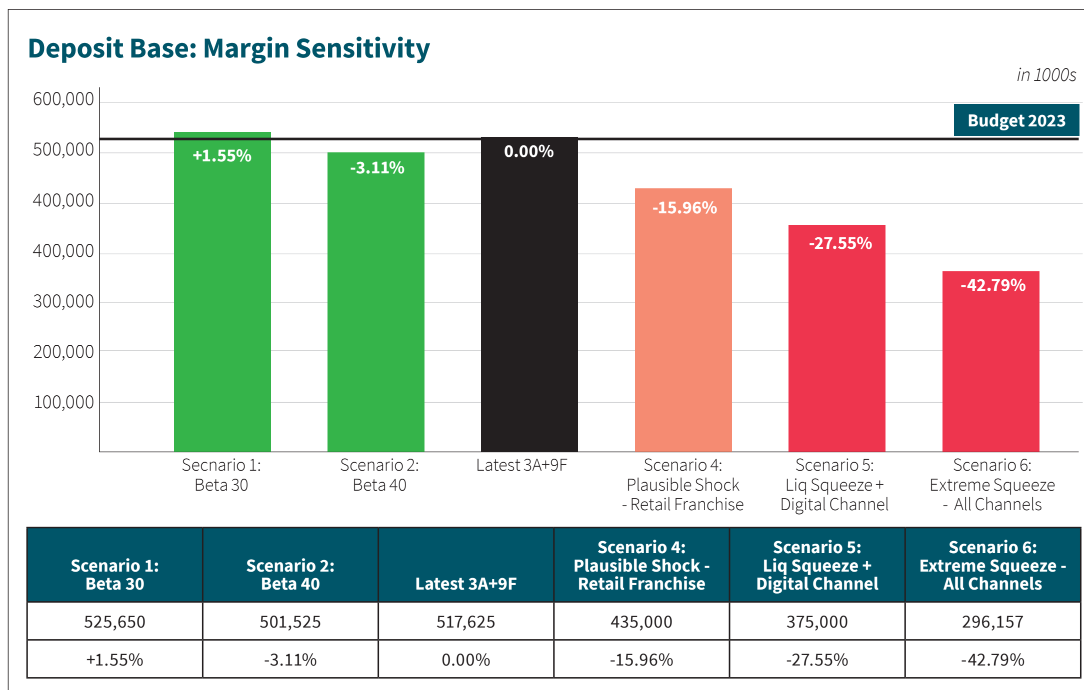
Excess cash is loading into bonds to seek yield, but what's the hidden cost? The common theme of investment policy choices for surplus retail (deposit-led) funding over the last 24 months has been to invest in marketable securities. Many institutions choose to hold these securities at amortized cost (AC) and presume to be held to maturity (HTM), come rain or shine, and from an accounting aspect, this doesn't have an impact on capital as AC portfolios do not have to mark to market on a regular basis, unlike available for sale (AFS) securities.

But what could happen if we see more rising rates in 2023, a worsening credit outlook, a deeper recession and a reduction in investor sentiment towards financial institutions and those securities portfolios that are held at amortized cost. Meanwhile, the middle classes, who are the bedrock of cheap funding through customer inertia, finally decide to seek a better yield for their shrinking savings. The future is uncertain and maybe we are reaching towards a crossroads.

Rising interest rates and a riskier outlook affects the discount curve, and so, the NPV of your securities portfolios is going to reduce. Accounting for AC requires disclosures in your report and accounts, but it typically doesn't pass through the P&L or reserves and hence doesn't immediately impact available capital in a financial forecast.

While you may not consider it a problem today if your securities are accounted for on an AC basis, "what if" springs to mind, and this can potentially move it beyond an accounting issue to a risk management topic around the future.





Scenario 1: Beta 30	Scenario 2: Beta 40	Latest 3A+9F	Scenario 4: Plausible Shock - Retail Franchise	Scenario 5: Liq Squeeze + Digital Channel	Scenario 6: Extreme Squeeze - All Channels
525,650	501,525	517,625	435,000	375,000	296,157
+1.55%	-3.11%	0.00%	-15.96%	-27.55%	-42.79%

What you need to do right now

"What if" scenarios and stress tests are a proven way to evaluate the future balance sheet, income and as an input to capital planning to assess a firm's risk appetite, given possible future market conditions.

For example, if there is a deeper recession and central financial institutions are forced to continue to raise financial institution rates to halt inflation, but energy prices don't tail off and the last decade of globalization comes to a harder stop, say through another geo-political event, then that could impact the manufacturing sector and cause layoffs.

Meanwhile, the above starts to impact your "safe and sticky" retail savers, who start to chase hot money rates and that starts to erode your non-maturing deposit balances (NMD). This then brings pressure to liquidate those AC securities, plus a wider upward customer repricing rate across your deposit books as a defensive response.

Sound farfetched? Or could it be an extreme yet plausible scenario for your firm?

One thing is certain in this scenario - both AFS and those AC securities are going to reduce in value further when it comes to liquidation day to pay back those excess deposits. If you might be selling at a loss, then you would also need to understand what the likely impact on your reserves and regulatory capital was, as well as the new shape of your NMDs, on the future balance sheet and NII and NIM terms.

Stress testing all your securities and deposit portfolios and understanding the impact on the underlying cashflows in extreme is key. Plausible scenarios are also relevant to consider and ensure those market-wide and/or firm-level shocks and changing depositor behaviour are fully evaluated when setting or re-calibrating your internal policies and limits.

Financial institution regulators will expect you to be on the front foot for emerging areas (liquidity, funding and investment policy, pricing, hedging, IRRBB and translating policy into hard and soft limits) within terms of scenarios and your analytic capability, whenever external events or monetary policy translates to changing expected valuations and predictability of earnings from your balance sheet.

We can help you have the answers to these questions before the regulators ask. Contact us today to learn how you can scenario and stress test all your portfolios, model deposit migration, cannibalisation, the impact of changing deposit betas and portfolio decay.

FIS® Balance Sheet Manager

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