NASHVILLE NOTES

'TTI' – Time to Insolvency

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By Jeff K. Davis

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I recently had dinner with a former colleague and long-time fixed income salesperson who was passing through Nashville. The conversation mostly centered around banks and the then-pending failure of First Republic Bank. He told me that he started his career in the early 1980s at UMIC Securities Corp., a Memphis-based institutional fixed income broker/dealer that was later acquired by Union Planters Corp., one of several regional banks that form today's Regions Financial Corp. via a series of mergers.

During his first year as a trainee, one of the executives who oversaw mortgage securities and mortgage loans introduced the term "TTI" – time to insolvency when describing savings and loans that were clients or prospects for UMIC.

> ***TTI for First Republic Bank and Silicon Valley Bank occurred in a blink of an eye by the thrift standard of the 1980s.***

TTI was a melting ice cube concept. During the early 1980s, much of the industry operated with an upside-down balance sheet like First Republic Bank, in which low coupon mortgages were funded with shorter duration liabilities that repriced far higher when the Federal Reserve pushed short-term rates toward 20%. Capital depletion was slow, but it sped up after regulatory changes were made in the early 1980s to loosen permissible investments to help the industry grow its way out of its asset-liability management hole ended badly.

TTI for First Republic Bank and Silicon Valley Bank occurred in a blink of an eye by the thrift standard of the 1980s. Horrendous asset-liability management decisions to invest a torrent of deposits garnered during the past several years in long-duration, low-coupon mortgages and securities upended whatever liquidity planning occurred as rates rose.

By chance, an executive of one of the rating agencies asked at a conference this past January if I was concerned about bank liquidity. I responded that I was not overly worried, other than Silicon Valley since its issues were visible to any of its sophisticated depositors who listened to what I thought was a panicky third-quarter 2022 earnings call. I was told, without any institutions being named, that a number of banks with certain characteristics were seeking deposit ratings, which presumably would address issues with corporate treasurers regarding where money could be deposited.

Looking back at the question was prophetic to me. I saw illiquidity as an earnings issue for banks that would be addressed through aggressive deposit pricing and greater reliance on wholesale funds to plug deposit outflows that could not be met by selling underwater securities, lest the loss create a capital hole. I think that is still the correct answer. Though the price action in some mid-sized regional banks may indicate more trouble to come, now that three large banks, albeit with unique deposit characteristics, have failed since March.

> ***I do not know how business models will evolve, but one change will be that more liquidity will be mandated by regulators. In a zero-rate world that is a bad outcome.***

JPMorgan Chase & Co. CEO Jamie Dimon pronounced the liquidity crisis induced by deposit runs for the sector to be over, other than a "smaller one" that may fail, in response to an analyst question during a call to review the deal for First Republic. What he did not say was that bank balance sheet illiquidity issues are over given the long duration of many bond and mortgage portfolios.

Apollo Global Management Inc. CEO Marc Rowan, in making a compelling case for private credit, raises a more pointed question about how the business model for regional banks will have to change if deposits can leave a bank in a whim. Maybe a regulatory tweak would be for operating accounts of businesses to have much higher FDIC insured limits, or no limits at all as some have proposed. However, this would not have protected high-net-worth depositors at First Republic and Silicon Valley who contributed to the deposit runs.

I do not know how business models will evolve, but more liquidity will be mandated by regulators. In a zero-rate world that is a bad outcome. It is not as bad if the liquidity can be invested to yield 4% to 5%, provided incremental funding costs to hold the liquidity are not equal to the rate or higher.

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