

What's Troubling our Banks? How Can I Avoid the Risks?

LINDA T. PATTERSON

MEEDER INVESTMENT

LPATTERSON@MEEDERINVESTMENT.COM

Who Would Have Thought...

- Four large bank failures occurred in 2023
 - But *all* banks can be affected
- Banks faced new challenges this year
- The regulation world changed
 - After 1999 Glass Steagall and after 2018
- Causal factors in 2023 from the market





Unique 2023 Bank/Bond Challenge

- Challenges normally focus on **sour loans**
 - The percent of *non-performing loans* would be high decrease capital
- 2023 challenge is based primarily in **rates**
 - Banks hold *bonds* – for monthly income and for use as collateral
 - MBS provide monthly income flow with the long maturities
 - Bonds bolster their capital positions
 - Banks may or may not hedge this position
 - As rates climbed, market prices fell on all security assets
 - Unrealized losses remain unrealized except when... draws begin



Behind the Curtain

Bank Tiers on Capital

- **AOCI** (accumulated other comprehensive income) includes two asset *tiers*
 - **AFS** 'available for sale'
 - **HTM** 'hold to maturity'
 - As rates rose up the AOCI moves to negative capital assets impacting *Net Worth*
- "Total Equity Capital"
 - Using normal accounting standards, i.e. GAAP
 - What they own versus what they owe
- But Common Equity Tiers are reported separately
 - Allowing banks to ignore market losses on portfolios



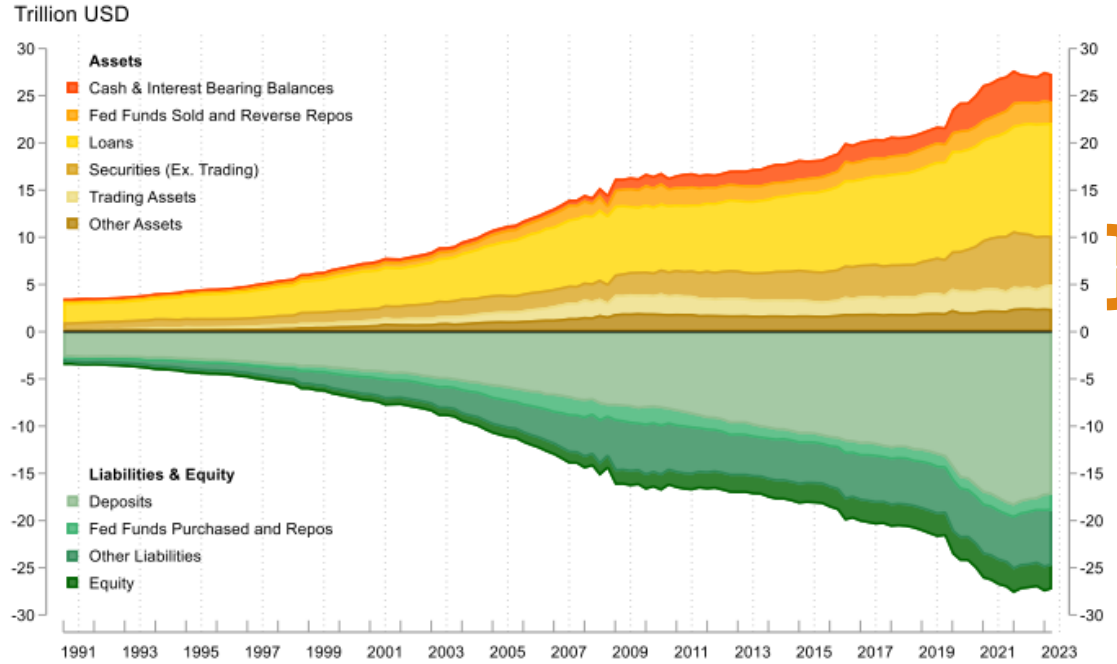
The Net Worth Shockwave

- **AFS**
 - indicates regulatory capital adequacy (Basel III banks) on statements

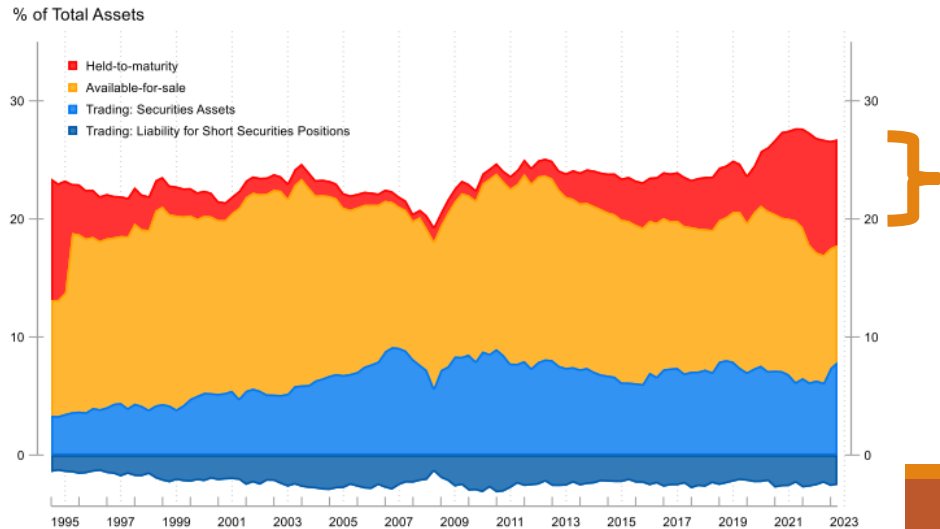
- **HTM**
 - Not shown on income statement – only in the notes – losses are masked
 - Losses not recognized until sold
 - Move to HTM lowers volatility of regular capital ratios
 - BUT also limits the ability to sell for liquidity

- A strong economy and excess liquidity brought assets then a shockwave

Balance Sheet Composition



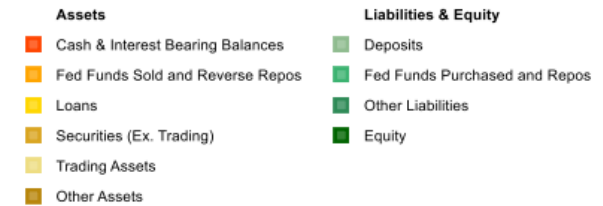
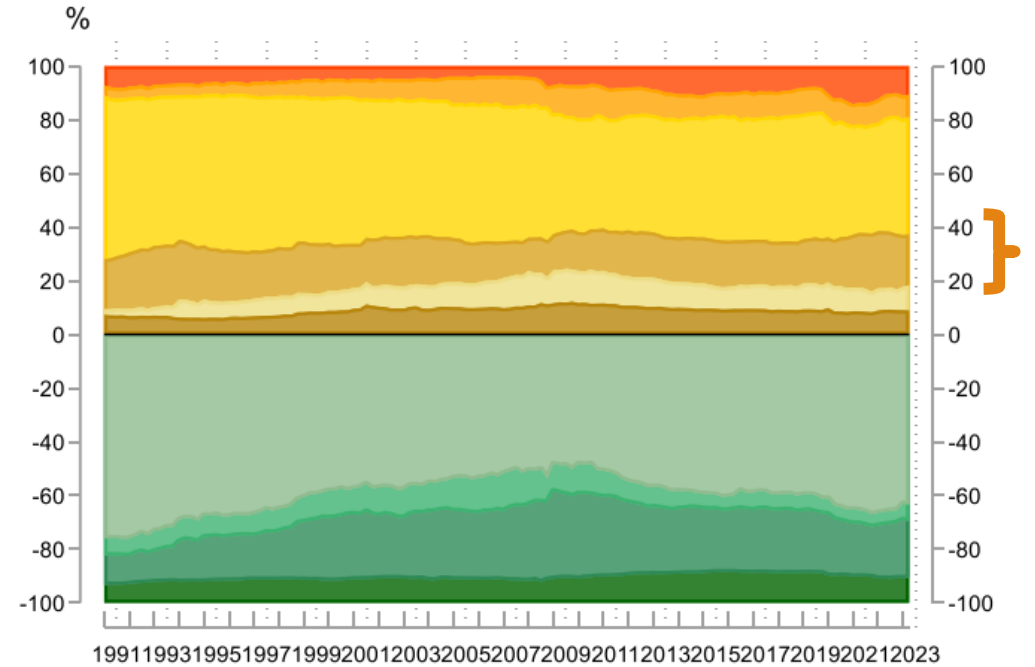
Securities Portfolios



Bank Holdings

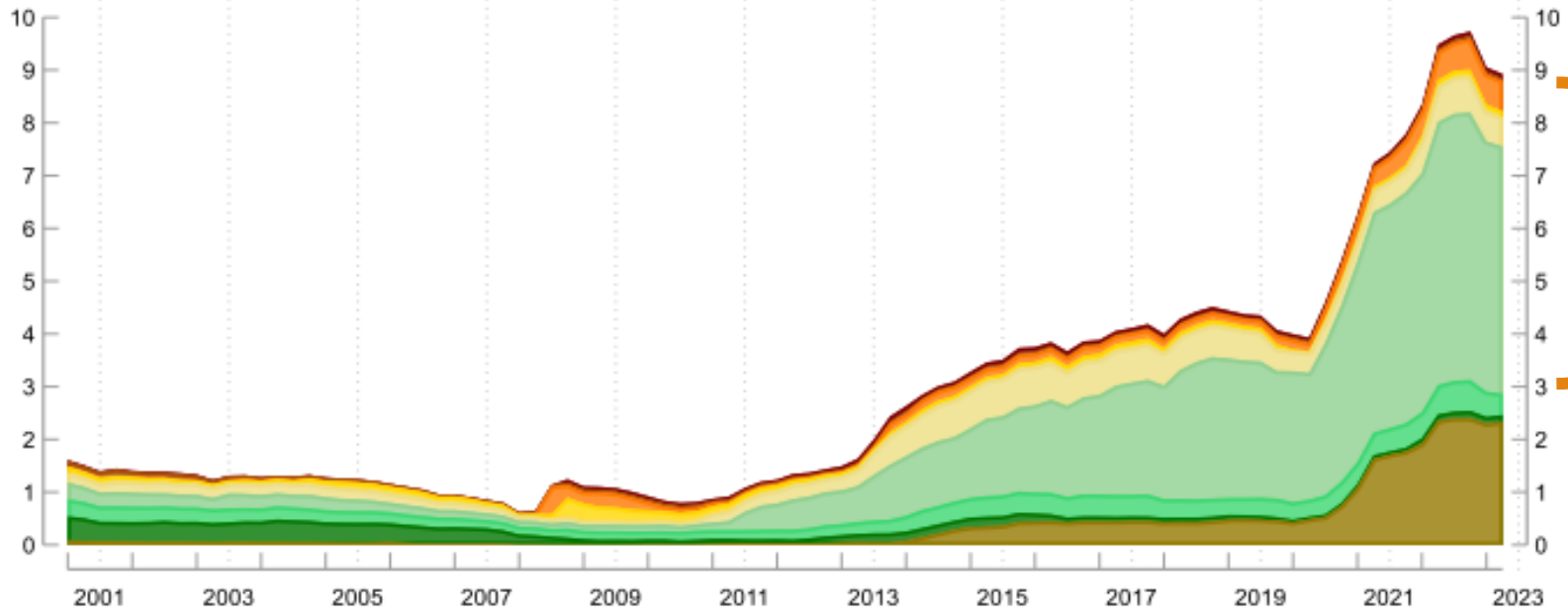
Source: FRED FRB

Balance Sheet Composition, Percent of Assets



Held-to-Maturity Securities

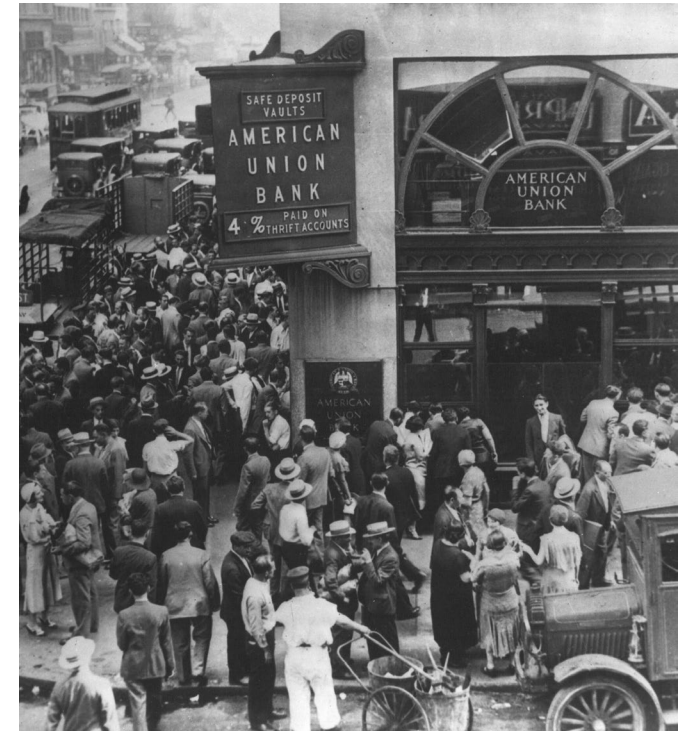
% of Total Assets



- U.S. Treasury Securities
- U.S. Government Agency Obligations
- U.S. State and Municipal Debt
- Agency Pass-through MBS
- Agency CMOs
- Non-agency MBS
- Asset Backed Securities
- Other Domestic Debt Securities
- Foreign Debt Securities

Why Does *Negative Net Worth* Matter

- HTM accounting does not reflect unrealized losses
- If withdrawals accelerate, bonds are moved to AFS at loss
- Creates insufficient funds to cover withdrawals i.e. a **run**





A Late Band-Aid from the Fed

- Bank Term Financing Program
 - Federal regulators created program in March 2023
- Saves bank from abruptly selling bonds on accelerated withdrawals
 - Banks borrow from Feds against their holdings



What Protects a Public Entity

- Collateral and FIRREA
- Bank account structures
- Bank ratings access and requirement to report credit changes
- Monitoring risks

Collateral Conditions Matter

- Collateral policy
 - This is not required – it is *assumed* to be in place (PFCA)
 - It should be in your investment policy and given to each bank

- Contents of the policy for all time and deposit relationships
 - Authorized collateral securities
 - Required margin of **102%** - on a *daily basis*
 - Substitution conditions
 - Bank responsibility for monitoring
 - Recognition and approval of custodian
 - Required monthly reports – must be required by the public entity

Sample Collateral Report

DATE COMPLETED:	January 05, 2023	COLLATERAL ANALYSIS AS OF:	December 31, 2022
CONTRA NUMBER:	PL-0000725	COLLATERAL ACCOUNT NUMBER:	WU2295
COLLATERAL WHEREHELD:	Bank of New York Mellon		

CUSIP	Description	CPN	Maturity Date	Original Face	Current Par	Market Value	Collateral Value
140XDN85	FN FM9414 3.500% 05/01/2047	3.50	5/1/2047	2,032,305.00	1,510,322.60	1,407,668.18	1,407,668.18
Total for Collateral Account Number: WU2295				\$2,032,305.00	\$1,510,322.60	\$1,407,668.18	\$1,407,668.18
Total for PL-0000725 :				\$2,032,305.00	\$1,510,322.60	\$1,407,668.18	\$1,407,668.18

You need to check these for market value regularly.

FIRREA

- **“Financial Institutions Resource, Recovery and Enforcement Act”**

- Regulation used by FDIC in bank closures
- Key components must be followed

- Requirements:

1. Depository/collateral agreement be **in writing**
2. Agreement be **approved by resolution** of the *Bank Board or Bank Loan Committee*
3. Resolution places agreement **in ‘official’ bank records**
4. Do not include a list of the specific initial securities pledged



Use Different Bank Account Types

Non-interest bearing accounts

Interest Bearing Accounts

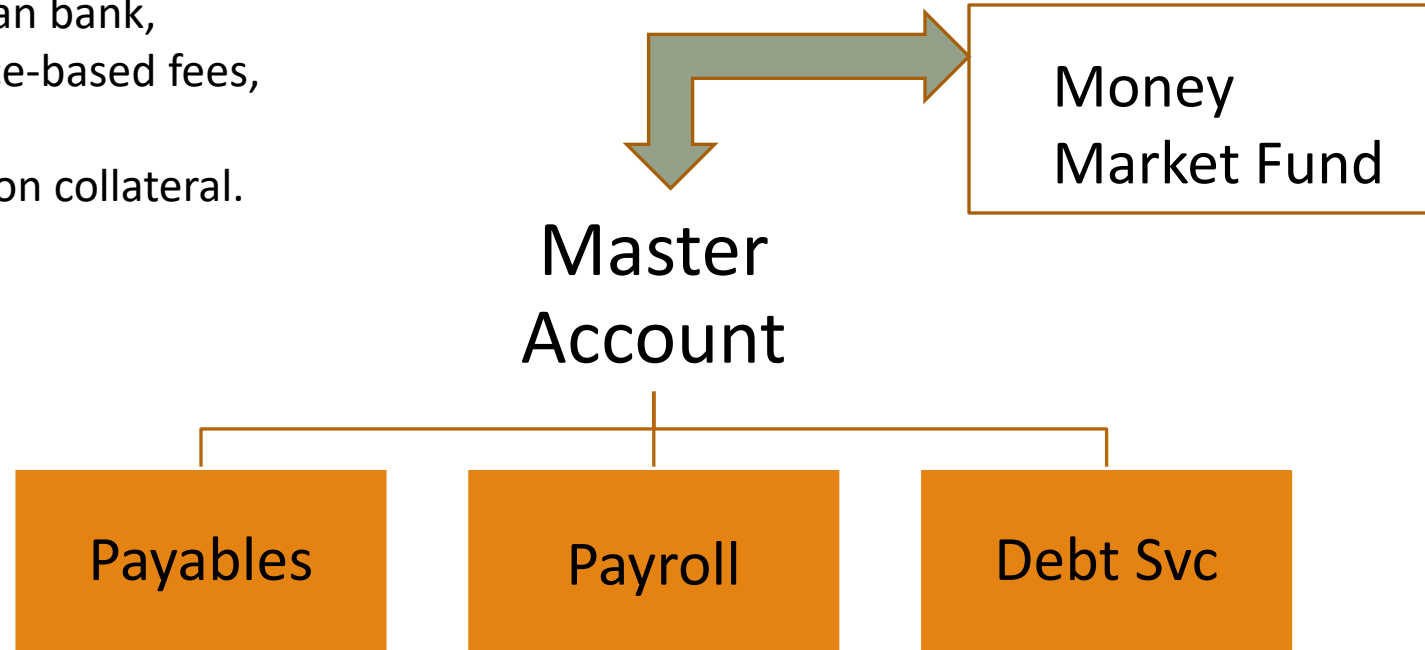
Money Market Accounts

Sweeps to AAA Money Market FUND

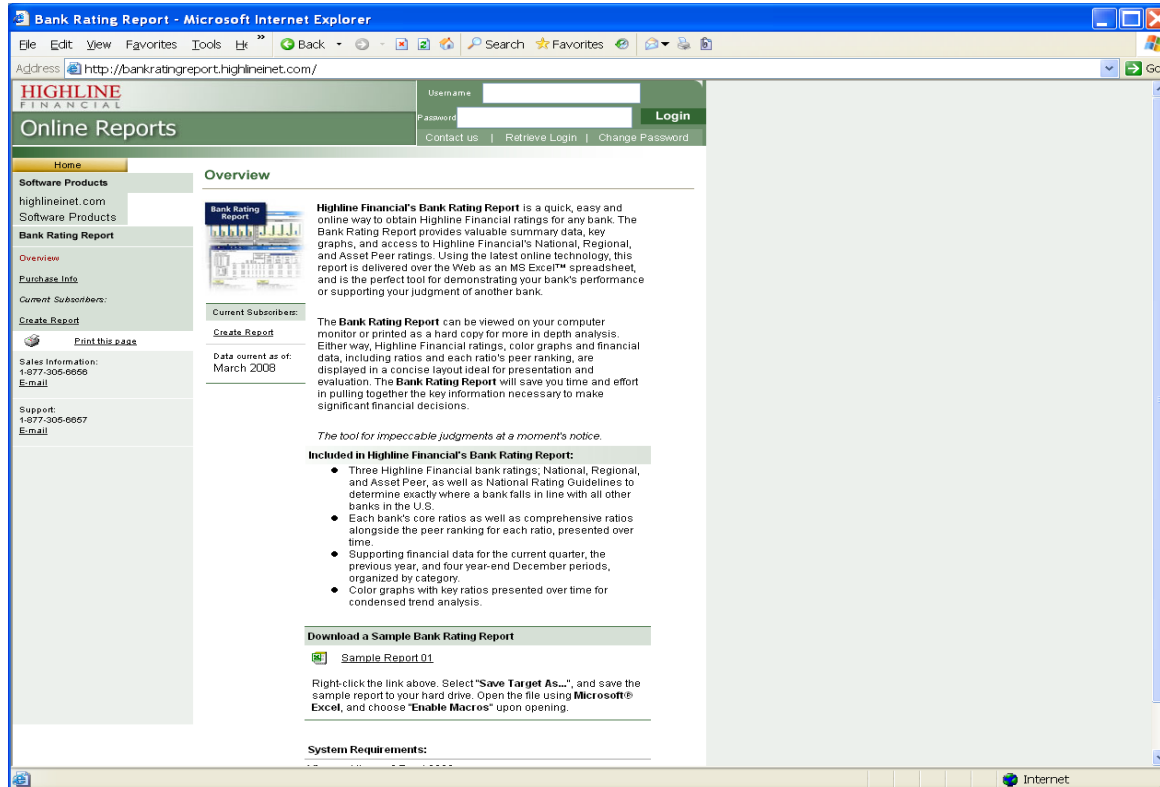
Spread Accounts

Why Sweep Accounts

Sweeps usually have higher interest rates than bank, eliminate balance-based fees, and reduce reliance on collateral.



Use a Bank Rating Agency



Bank Rating Report - Microsoft Internet Explorer
Address: <http://bankratingreport.highline.net/>

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Overview

Highline Financial's Bank Rating Report is a quick, easy and online way to obtain Highline Financial ratings for any bank. The Bank Rating Report provides valuable summary data, key graphs, and access to Highline Financial's National, Regional, and Asset Peer ratings. Using the latest online technology, this report is delivered over the Web as an MS Excel™ spreadsheet, and is the perfect tool for demonstrating your bank's performance or supporting your judgment of another bank.

The **Bank Rating Report** can be viewed on your computer monitor or printed as a hard copy for more in depth analysis. Either way, Highline Financial ratings, color graphs and financial data, including ratios and each ratio's peer ranking, are displayed in a concise layout ideal for presentation and evaluation. The **Bank Rating Report** will save you time and effort in pulling together the key information necessary to make significant financial decisions.

The tool for impeccable judgments at a moment's notice.

Included in Highline Financial's Bank Rating Report:

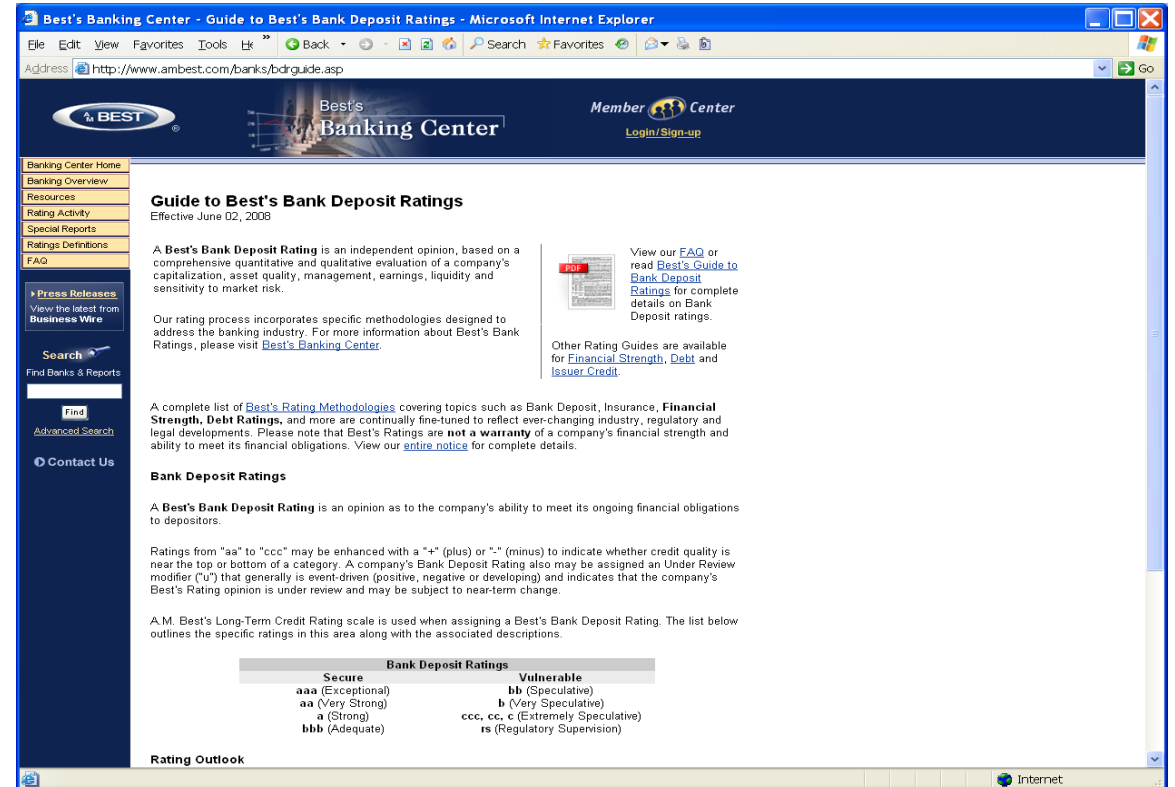
- Three Highline Financial bank ratings: National, Regional, and Asset Peer, as well as National Rating Guidelines to determine exactly where a bank falls in line with all other banks in the U.S.
- Each bank's core ratios as well as comprehensive ratios alongside the peer ranking for each ratio, presented over time.
- Supporting financial data for the current quarter, the previous year, and four year-end December periods, organized by category.
- Color graphs with key ratios presented over time for condensed trend analysis.

Download a Sample Bank Rating Report

[Sample Report 01](#)

Right-click the link above. Select "**Save Target As...**", and save the sample report to your hard drive. Open the file using **Microsoft® Excel**, and choose "**Enable Macros**" upon opening.

System Requirements:



Best's Banking Center - Guide to Best's Bank Deposit Ratings - Microsoft Internet Explorer
Address: <http://www.ambest.com/banks/bdrguide.asp>

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Effective June 02, 2008

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Bank Deposit Ratings

A **Best's Bank Deposit Rating** is an opinion as to the company's ability to meet its ongoing financial obligations to depositors.

Ratings from "aa" to "ccc" may be enhanced with a "+" (plus) or "-" (minus) to indicate whether credit quality is near the top or bottom of a category. A company's Bank Deposit Rating also may be assigned an Under Review modifier ("U") that generally is event-driven (positive, negative or developing) and indicates that the company's Best's Rating opinion is under review and may be subject to near-term change.

A.M. Best's Long-Term Credit Rating scale is used when assigning a Best's Bank Deposit Rating. The list below outlines the specific ratings in this area along with the associated descriptions.

Bank Deposit Ratings	
Secure	Vulnerable
aaa (Exceptional)	bb (Speculative)
aa (Very Strong)	b (Very Speculative)
a (Strong)	ccc, cc, c (Extremely Speculative)
bbb (Adequate)	rs (Regulatory Supervision)

Rating Outlook

If you are Small: Use the FDIC Coverage

- Based on type of account – a change in definitions
 - All time and savings accounts = \$250,000
 - Includes *NOW* and money market accounts
 - All demand accounts = \$250,000
 - Includes interest bearing and non-interest bearing
- Based on location of bank
 - If the bank is outside the state all deposited are lumped together
 - This has changed from ‘headquarters’



Okay, So the Worst Happens....

- Friday Watch: Banks are always closed on close of business Thursday
 - [Fdic.gov](https://www.fdic.gov) lists the closings
- Regulators and FDIC step in and close the bank
 - FDIC will only recognize those assets protected under a FIRREA executed agreement
 - FRB, Comptroller of Currency, FDIC
 - Three-day “cure period”
- Assets are restricted by the custodian
 - Without a “cure” the assets are under the public entity control
 - You – or the custodian – sell the assets in open market
 - Keep 100% of your principal and interest and return rest to bank regulators

A Fire-escape Bank ?

- Don't forget the termination clause
- A commercial account in another bank
 - Local Gov't Code Title 4, Subtitle C
 - If a depository "suspends business" you contract a "special depository"
- ACH files ready to transfer
-

UNDERSTAND THE BANK'S POSITION
AND THEN
BANK LIKE YOU MEAN IT.

Linda T. Patterson
Meeder Investment
512-230-1336
lpatterson@meederinvestment.com