The Problem

• Since 2021, the Fed has raised short-term rates by 4.5%
  – long-term rates, which reflect expected future short rates, are up 2.5%
• Banks hold $17T of long-term loans and securities with average duration 4 years
  – implied loss of $0.025 \times 4 \times 17 = $1.7T
  – not hidden or complicated
  – very large compared to $2.2T bank equity
Bank Stocks Held Up Through February; Down 25% in March

KBE Bank Stock Index
Fed funds rate (right)
The Deposit Franchise

• What makes banks special is issuing deposits
  – people like deposits for their convenience and safety
  – willing to accept very low deposit rates
• When rates rise, deposits become much more profitable for banks
  – “deposit beta” only 0.2 – deposit rates rise only 0.2% for every 1% Fed funds rate increase
  – banks capture the other 0.8 x Fed funds rate
Deposit Rates

- Savings deposits
- Interest checking
- 12-month CD
- Fed funds rate

Alexi Savov
Stable Net Interest Margin

Source: Drechsler, Savov, and Schnabl (Journal of Finance 2021)
The Deposit Franchise Hedge

• There are $17.5T of deposits
  – average deposit rate about 0.9%
  – banks earning 4.5-0.9 = 3.6% deposit spread
  – 0.036 x 17.5 = $630B more income per year!

• Enough to offset losses on assets in 3 years
  – deposits went from unprofitable to extremely profitable
  – baseline estimate suggests a full offset
  – explains why bank stocks didn’t fall through Feb
Risks

• The deposit hedge only works if most deposits stay in the bank
  – depositors may run if they are uninsured
    • a bank run destroys the deposit franchise and the hedge fails
  – deposit betas may rise if depositors seek out higher-paying alternatives
    • if the deposit beta doubles to 0.4, only 1/3 of losses offset
    • the risk is larger for regional banks (big banks could see betas fall)

• Key risks going forward are to the deposit franchise

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