February 27, 2025

More Lessons from 2023

Columbia University/BPI Bank Regulation Research Conference

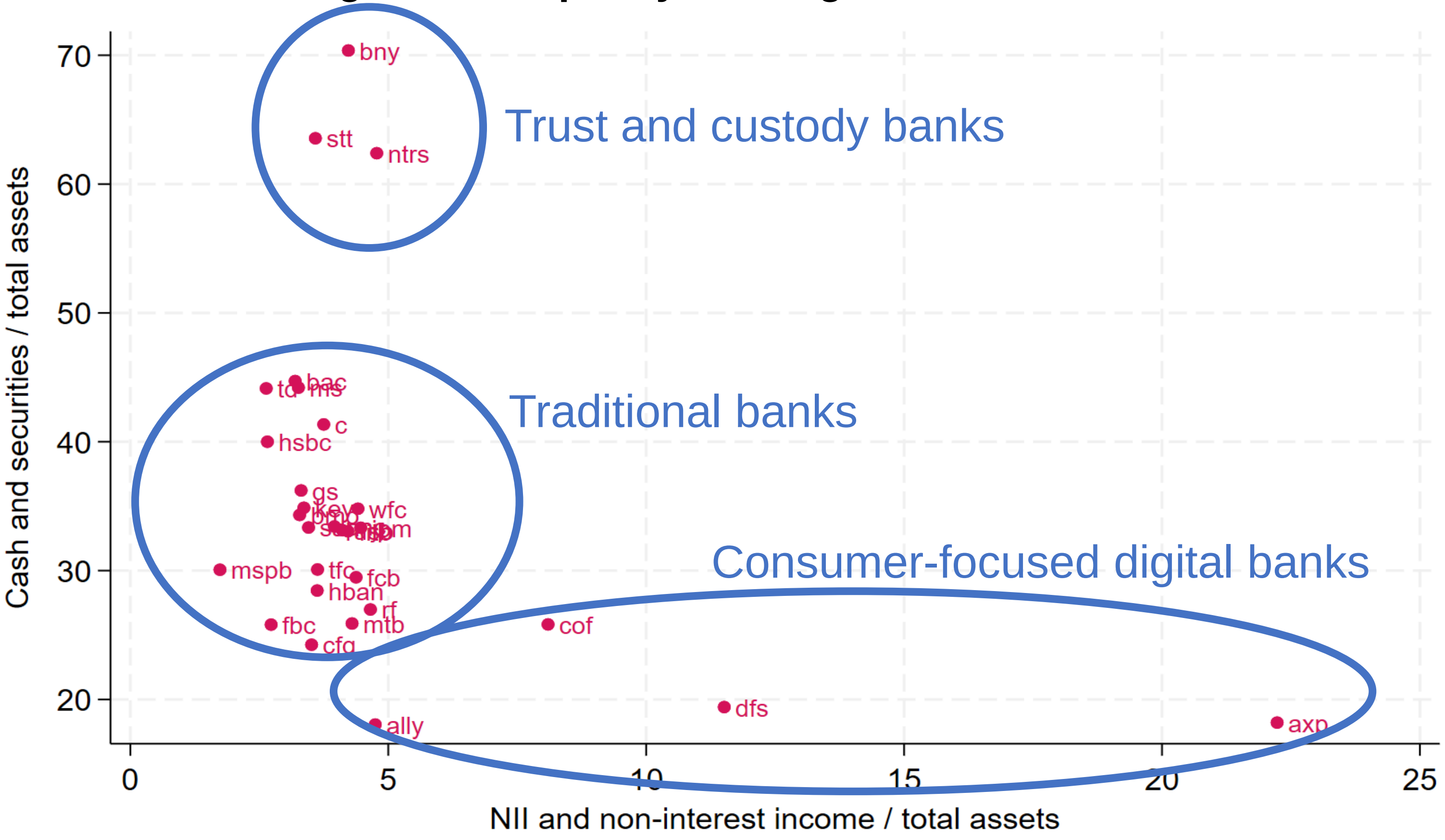
Tim Schmidt, Corporate Treasurer, KeyCorp

Executive Summary

- ***Underwater: Strategic Trading and Risk Management in Bank Securities Portfolios*** **(Fuster, Paligorova, Vickery)**
  - *Primary study finding*: Two frictions (regulatory capital treatment of unrealized losses and hedge accounting) discouraged banks from actively managing investment portfolio interest rate risk when rates rose sharply during 2022-23
  - I offer a practitioner's perspective on how the interplay between post-GFC bank regulation, diverse bank business models and risk management frameworks played a role in the 2023 banking sector stress
- ***Bank Branch Density and Bank Runs*** **(Benmelech, Yang, and Zator)**
  - *Primary study finding*: Banks with low branch density had/are likely to have high deposit balance variance because they rely on digital banking and high deposit rates to attract high uninsured balances
  - Using consumer-focused digital banks, which were excluded from the study, I offer a counterpoint to illustrate that deposit balance stability isn't necessarily dependent on branch density, but rather depositor type and insurance coverage play important roles

Bank Portfolios Reflect Diverse Business Models

Large Bank Liquidity Holdings and Revenue Generation



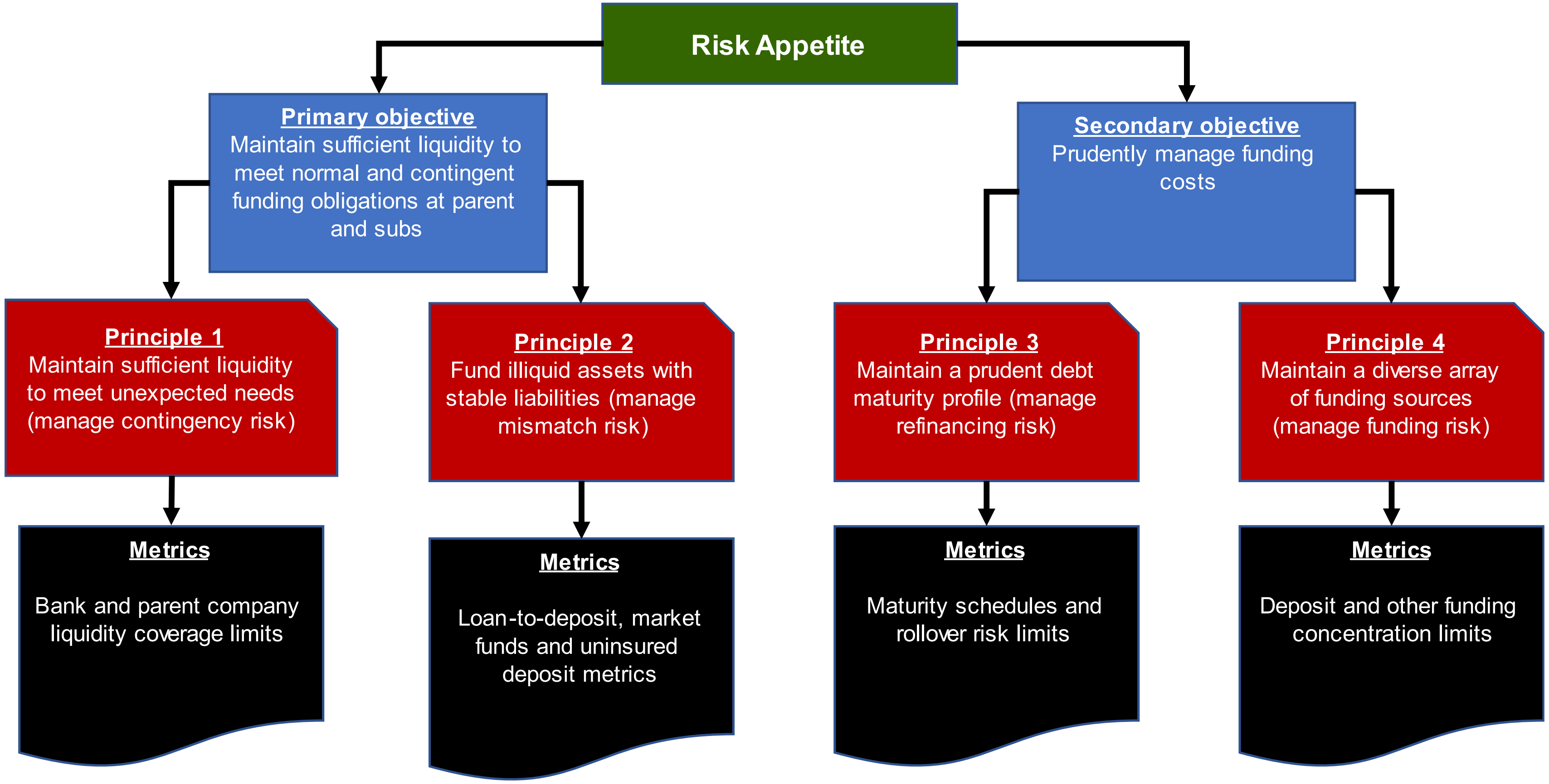
Source: Bank call reports as of December 31, 2024

Diverse Business Models Influence Bank Risk Management Priorities

- Banks manage their investment portfolios to serve three primary purposes, not necessarily in this order:
    - Store liquidity
    - Manage interest rate risk
    - Generate earnings

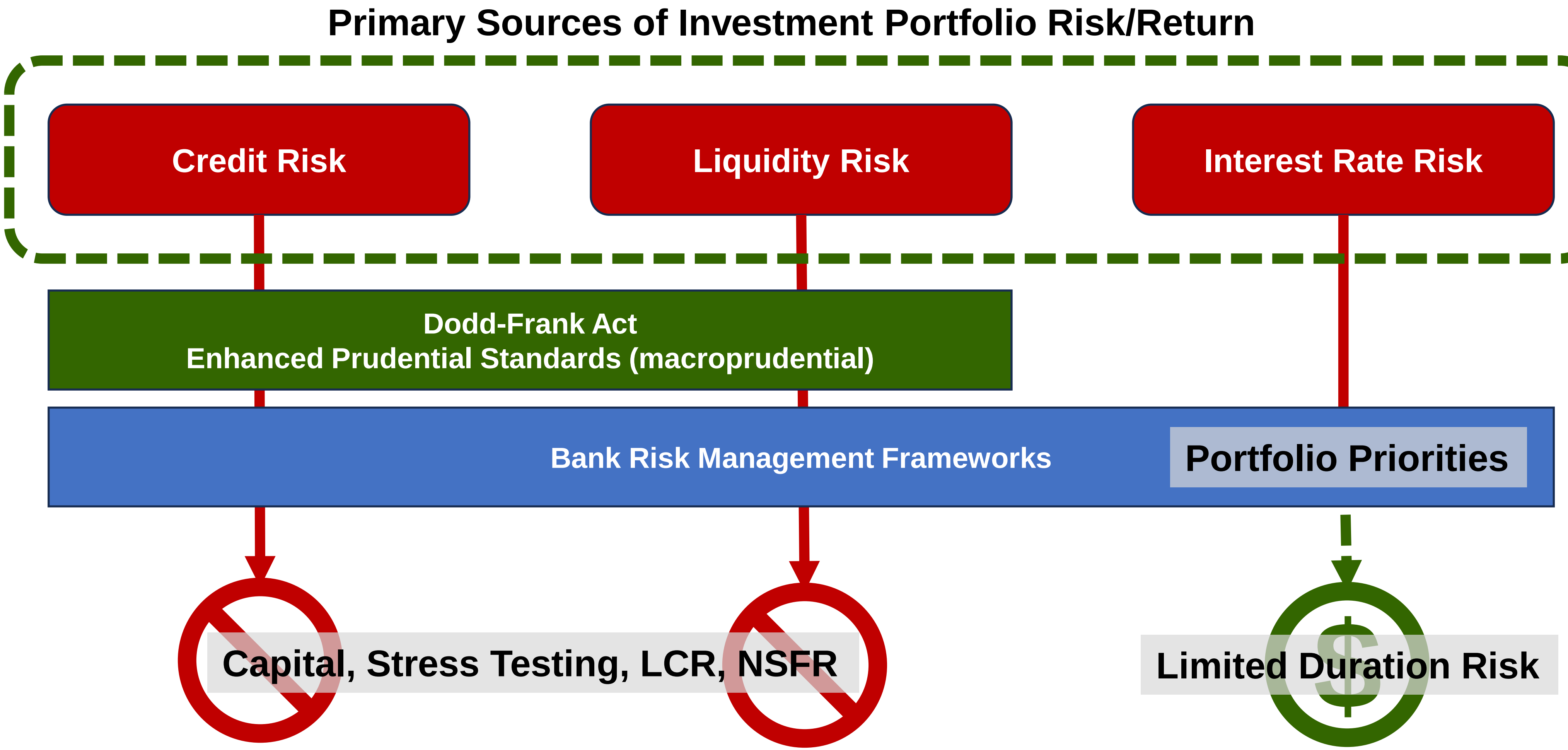
- How banks prioritize these purposes depends on several factors, including regulatory rules, risk management frameworks, and business models

KeyBank Liquidity Risk Management Framework



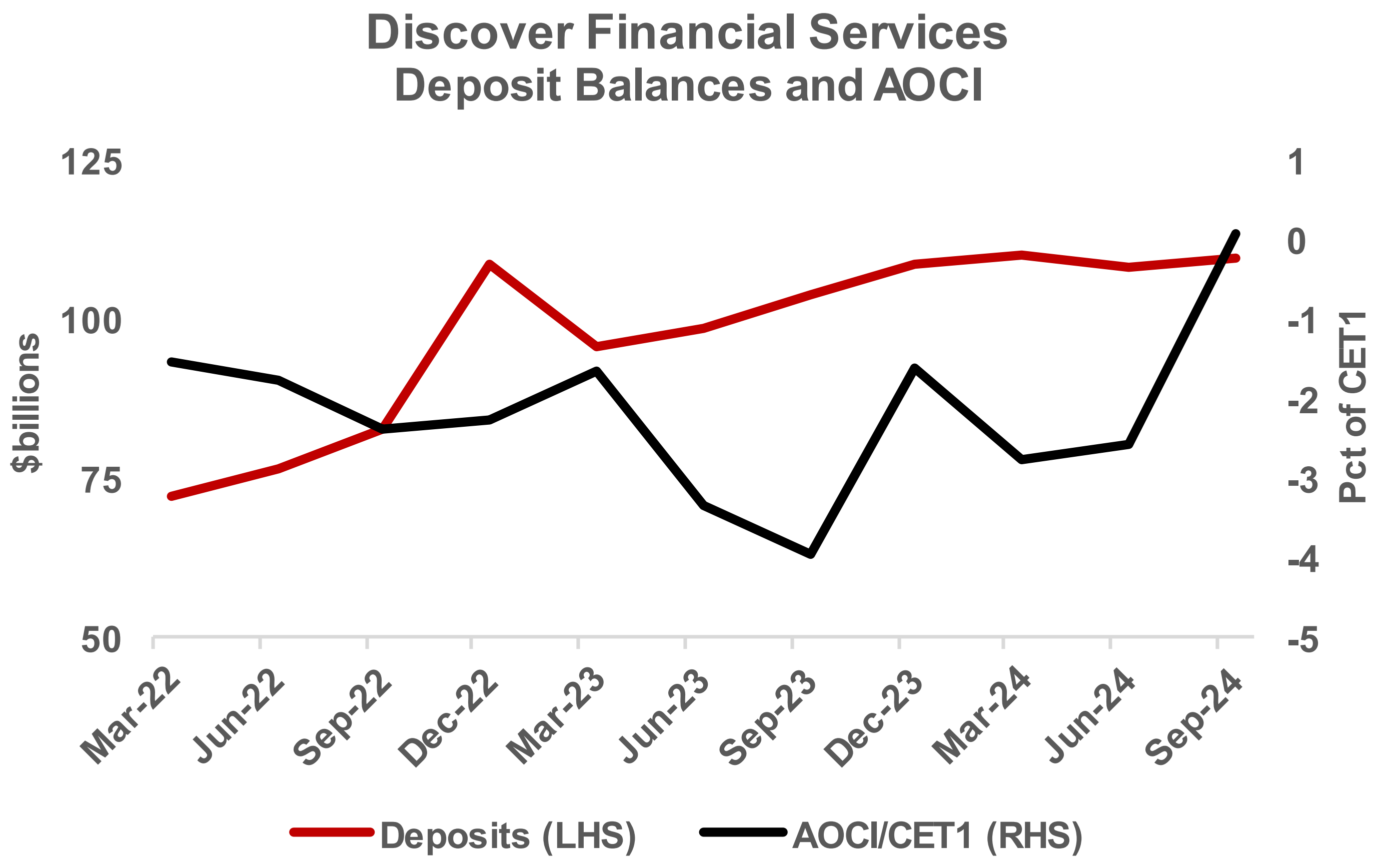
Frameworks Govern Duration Risk Outside Macroprudential Regulation

Dodd-Frank Enhanced Prudential Standards addressed credit and liquidity risks with a macroprudential, ratio-based approach that did not differentiate among business models. Interest rate risk was unaddressed and is subject to microprudential supervision.



Depositor Type and Insurance Influence Deposit Balance Stability

Consumer-focused digital banks provide a counterpoint to branch density as a determining factor behind deposit stability.



Source: DFS 10-Qs and 10-Ks

Conclusions

- **Bank regulation still largely reflects a post-GFC macroprudential focus on capital and liquidity with interest rate risk left to microprudential oversight and diverse bank risk management frameworks**
  - There's no good substitute for balanced, well-informed local regulation, which can be challenging to do consistently well across a large and diverse banking system

- **Banks respond rationally to regulatory and economic incentive systems, so regulation should account for the different incentives inherent in large banks' diverse business models**
  - Studies like those discussed here are helpful in highlighting frictions and economic structures that may create undesirable incentives and responses in adverse environments

- **Regulatory policy responses to the 2023 banking sector stress should reflect the realities of an evolving banking system**
  - Regulators should look though the contributing factors highlighted by the authors to the root causes of the stress
  - Effective regulation creates thoughtful, tailored incentive systems that recognize differences in diverse banking business models