SMBC SMBC Group

US Rates Strategy

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Dash for cash: Liquidity recycling during the Iran conflict

The FHLBs play a key role in recycling liquidity between money funds and banks through discount notes and advances. While we see some evidence of a dash for cash following the Iran conflict it is difficult to separate the effect from a stronger economy and demand for working capital.

- During episodes like the 2020 and 2023 **"dash for cash"** C&I loan demand suddenly increased. Banks typically meet this demand through FHLB advances.

- In turn, the FHLBs' finance these secured loans by issuing short-term debt largely to money funds whose balances increase during a cash dash. **Significantly, this liquidity recycling occurs outside the Fed's balance sheet**.

- There is some evidence of an Iran conflict-related dash for cash. FHLB discount notes outstanding increased 25% in April. Money funds absorbed roughly 80% of this supply.

- But corroborating evidence from C&I lending and non-financial CP issuance is weak. Both were trending higher before the conflict. **This makes separating precautionary liquidity effects from stronger demand for working capital difficult**.

- That said, if the issuance pattern of discount notes only reflected a dash for cash, its magnitude this April would make it roughly the same size as the one following the SIVB collapse.

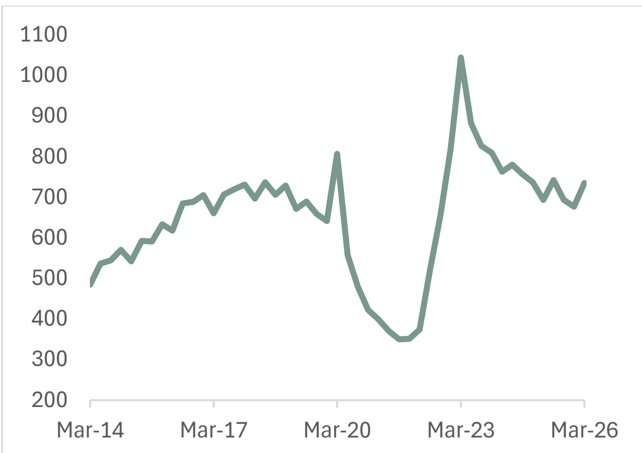
Liquidity ecosystem

The FHLBs were set up during the Great Depression to facilitate mortgage lending. Commercial banks, insurance companies, and credit unions are system members and provide capital to the FHLBs. In return, they can borrow from the FHLBs through secured loans called advances. Advances are secured mostly with single family mortgages and commercial real estate.

At the end of March, FHLB advances totaled $735bn, or 56% of their total assets (Figure 1). **Demand for advances is variable**; **it rises sharply during periods of financial stress like COVID and the March 2023 SIVB failure and then quickly falls off**. More than half of outstanding advances have maturities shorter than a year – this share also increases in periods of stress. The FHLBs hold another $80bn worth of mortgage loans that were either originated or purchased by their member banks. These are generally conventional loans that have a government guarantee or insurance. **The FHLB's regulator, the FHFA defines advances and mortgage loans held as "primary mission assets"**.[1]

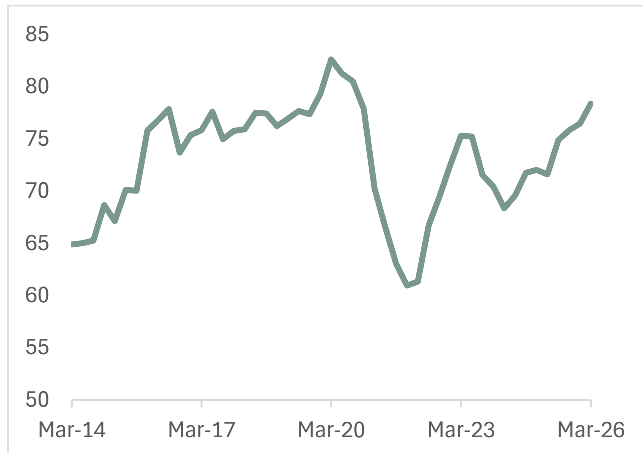
The FHLBs finance their assets by issuing debt that trades at a tight spread to US Treasuries. Because a significant portion of their assets is short maturity, their debt is also shorter maturity. Under 1y debt (coupons and discount notes) was 78% of their total obligations in March (Figure 2). Money market funds hold a significant amount of this – we estimate that at the end of March they held about 86% of the FHLB's debt under 1y.

Figure 1: Total advances ($bn)



Source: FHLB, SMBC Nikko

Figure 2: Sub-1y debt (%)



Source: FHLB, SMBC Nikko

Dashing for cash

FHLB advances are part of a liquidity ecosystem that expands in stress periods and contracts once the stress has abated. During episodes like COVID and March 2023, the demand for cash and immediately accessible liquidity rise. In a "dash for cash" bank clients rush to draw on their unused credit lines – even if they do not need the immediate liquidity. Instead, they raise precautionary cash like travelers use ATMs ahead of a trip; better to have extra liquidity than need to borrow it later. Ahead of the nationwide shutdown in mid-March 2020, banks C&I loan demand jumped $185bn or 7.3%.

Similar – although significantly smaller – credit line drawdowns occurred following the invasion of the Ukraine (February 2022) and after the SIVB collapse (March 2023). C&I lending increased by about $20bn in the week of both episodes. In each case, the borrowing was larger-than-normal and higher than the trend in prior weeks. The extra liquidity raised is pushed toward the largest banks, Treasury bills, or gov-only money funds. During SIVB failure uninsured deposits shifted from smaller to larger banks.

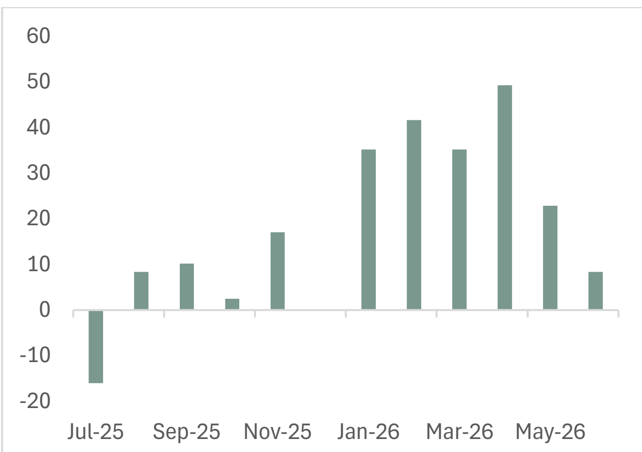
[1] Until this month's recission, the FHLBs were required, on average, to maintain a ratio of 70% between their primary mission assets and the total outstanding debt. This created a tension between their liquidity investments in fed funds and repo (not counted as primary mission assets) and the debt issued to finance them (included in the denominator of the ratio).

Banks can meet the sudden increase in loan demand by selling assets or borrowing against them. They face three alternatives for the latter – the repo market, the Federal Reserve's liquidity programs (discount window and SRP) or FHLB advances. Repo is available for securities collateral across all three channels. By contrast, whole loans cannot be repo'd in the market. However, banks are reluctant to borrow from the discount window and despite over $3trn in pre-placed collateral at the Fed, they prefer to use FHLB advances.

Iran-conflict

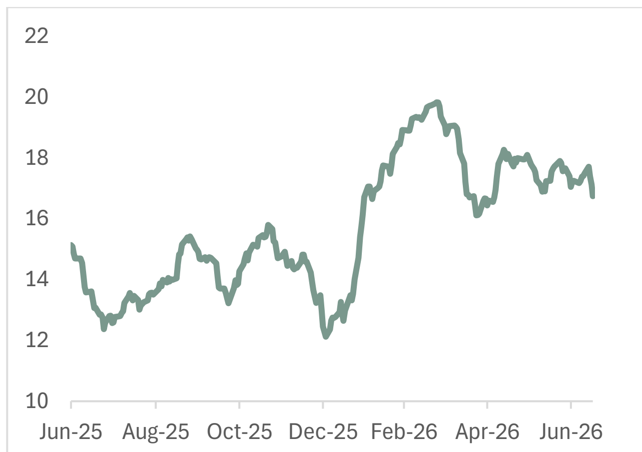
This April FHLB advances increased 25% from a month earlier and C&I lending rose nearly $50bn in the month suggesting a cash dash occurred during the Iran conflict. But while the increase in April borrowings is larger than surrounding months, C&I lending was trending higher before the start of the conflict (Figure 3). Similarly, non-financing CP issuance (both AA and A2/P2) also accelerated before the conflict (Figure 4).

Figure 3: C&I loans (chng, $bn m/m)



Source: FHLB, SMBC Nikko

Figure 4: Non-financial CP daily issuance ($bn)



Note: 20d average. Source: FHLB, SMBC Nikko

Both C&I lending and non-financial CP issuance have cooled since spring which suggests that some of the April increase in discount note issuance may have been driven by a precautionary liquidity effect. Indeed, since peaking in April, discount notes outstanding have shrunk 27% ($143bn) and returned to their February level. On the demand side it is difficult to find evidence of a flight to quality because tax payments were pulling money out of gov-only money funds. That said, money funds increased their FHLB allocations – absorbing much of April's increased supply. Their holdings rose $84bn (11%) in April accounting for most of the $107bn increase in FHLB debt. Since April, money fund holdings have continued to increase albeit at a slower pace.

As a result, while we suspect there was a dash for cash in April, it is difficult to separate the precautionary demand for liquidity from an unrelated increase in working capital demand predating the conflict. *If the entire increase* in April discount note issuance was driven by the demand for precautionary liquidity, then the Iran-conflict's cash dash was about the size of the one following the SIVB collapse.

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