



Monthly Newsletter

March 2023

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The Fed's low interest rate policy comes home to roost.

Over the past month, the Federal Reserve Bank's monetary policy since the Covid pandemic and Great Financial Crisis has come home to roost. To recap, over the past many years, the "Fed" has forced interest rates to record low levels and has flooded the economy with money. Now, with inflation reaching unacceptably high levels, the Fed is trying to reverse course to reduce inflation but that is having unintended consequences.

In recent years, a very profitable trade for banks has been to borrow funds for short periods of time, at historically low interest rates, while lending that money for longer periods of time, at relatively higher rates. This is sometimes referred to as "borrow short / lend long."

The profit comes as short term rates decline, and long term loans earn a constant rate of return, so the banks earn higher and higher profits as their cost of funds for the long term loans keeps falling. This is a significant part of how the Fed engineered a banking recovery from the Great Financial Crisis. Banks made poor lending decisions before the crisis and that resulted in losses, so the Fed gave banks a profitable way to recoup those losses by allowing them to "borrow short / lend long" over the course of many years. The Fed was hoping that it could slowly reverse this program and was trying to do so when the Covid pandemic hit, which then caused it to push rates even lower.

Now that the Fed is reversing course once again, as it is being forced to deal with high inflation, banks that made too many long term loans at historically low interest rates are losing money on those loans, as short term interest rates rise. The interest rate curve has also inverted, which means that long term interest rates are now lower than short term rates.

When this problem recently became apparent at Silicon Valley Bank, a relatively obscure regional bank that catered to technology companies, many depositors started withdrawing funds at a record pace. This turned into a modern day "bank run" as depositors learned of it on social media and they all went to withdraw their funds from an app on their phones. This "bank run" was stopped by the Fed when it promised to guarantee all deposits, regardless of size. However, stopping the "bank run" does not address the more fundamental problem that caused the run in the first place. We have yet to see how the Fed will address the fact that many banks will lose significant amounts of money as a result of rising interest rates.

Explanation of how trust funds are held by California West.

As a real estate management company, California West is regulated by the Department of Real Estate (DRE). One of the DRE requirements that we must follow (for good reason) is to hold all client funds in a specially designated trust account.

An improperly titled trust account would mean that the FDIC insures only up to \$250,000 of a property management company's aggregate deposits, not its individual client deposits.

Most and perhaps all of the large banks in the United States do not offer trust accounts that comply with the DRE's requirements. As a practical matter, we are therefore forced to use regional banks. This is not exactly a bad thing, *per se*, because regional banks tend to offer more personalized service and better long term relationships, such as by offering trust accounts to property management companies. However, being unable to use large banks in the present environment is a bit concerning as the Fed seems to be adding regulations that may have the effect of forcing regional banks to merge with large banks.

One major benefit of a properly titled trust account is that beneficiaries of the account, i.e. clients of California West, receive FDIC insurance on their funds up to \$250,000. An improperly titled account would mean that the FDIC insures only up to \$250,000 of a property management company's aggregate deposits, not its individual client deposits.

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At California West, we maintain significant relationships with two regional banks. Our clients' operating funds are deposited in one bank. We use the second bank for security deposits that clients have asked us to hold. Not all clients ask us to hold security deposits for them and we determine on a case-by-case basis whether this is necessary or wise.

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The security deposits are held in separate accounts under our clients' tax identification numbers. This allows clients to earn interest on the accounts. The tedious part of this, though, is that transferring funds back and forth between accounts can take time. As a result, we will often refund deposits to tenants from a client operating account and then periodically adjust the balance in savings to match security deposit liability.

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Client operating funds are held in a non-interest bearing general trust account under California West's tax identification number. We keep a separate record of all trust funds in our accounting software and the account is appropriately titled and is reconciled on a weekly basis.

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Broker: Derek Banducci
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Within our client operating accounts, we set reserve amounts on a case-by-case basis, as agreed with each of our clients. This reserve amount allows us to keep a certain amount of money in the operating account for unexpected expenses. When we distribute money to clients each month, we hold back the reserve amount and we distribute everything that remains to our clients.