Has the Regional Banking Crisis Passed or Paused?

Last month was a stark reminder that a bank run these days isn't what it used to be. The classic image of a bank run for many of us are Depression era photos from the early 1930s of long lines of panicked folks queued up for blocks waiting to enter a bank and withdraw their money, or James Stewart's selfless character, George Bailey ditching his honeymoon plans and handing out his wedding loot to a horde of swarming depositors to keep the Bailey Building & Loan from going under during a run on the bank in the movie classic, *It's a Wonderful Life.*

Two bank runs in March were not such visual spectacles but were no less consequential, conducted on a large scale in back offices and family offices across the country with the help of modern day technology that quickly spread the word and moved many billions of dollars within a few days. The immediate cause of these bank failures was the same as it has always been since the start of reserve-based banking—a crisis of confidence by depositors, justified or not, creating a liquidity squeeze at these institutions that pushed them into receivership by regulators.

Last month began with an announcement by Silvergate Capital, a bank with a significant digital currency business, on March 8th that it would voluntarily liquidate after an exodus of deposits, soon followed by the closings of Silicon Valley Bank (SVB) and Signature Bank (SBNY) by regulators—the first bank failures since 2008 and the second and third largest on record. Financial market turmoil ensued, slashing banks' valuations, stoking fears of contagion, and moving unprecedented amounts of deposits from regional banks to money center banks.

By month end, the regional banking sector and depositor money flows had stabilized due mostly to an aggressive response by the Fed and bank regulators to make liquidity available to banks who need it and to protect all depositors of these failed banks while beginning the process of transitioning their assets and deposits to willing buyers. In particular, the Fed's Bank Term Funding Program (BTFP), a lending facility introduced on March 12 to provide banks with secured loans on eligible securities for up to a year, has calmed financial markets by mitigating banks' need to sell investment securities (and realize losses) to meet deposit withdrawals. Banks have seized the opportunity to access this liquidity window, with the Fed's balance sheet again soaring since the BTFP began.

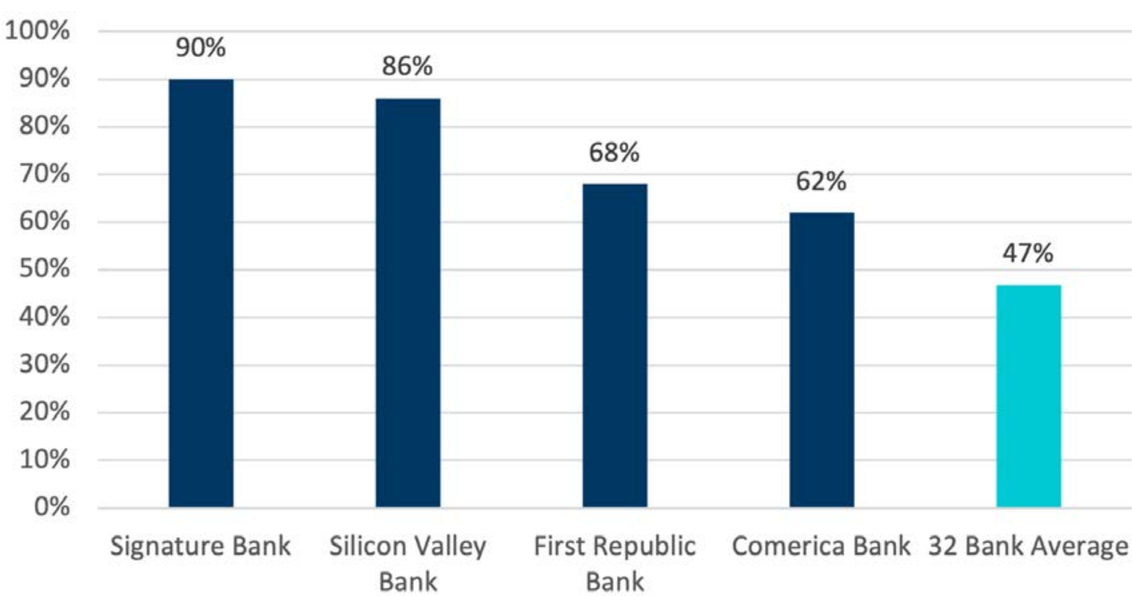
However, this is a stopgap measure that will expire next year while interest rate risk and duration mismatch will remain an ongoing issue of varying degree for banks should interest rates remain elevated. Moreover, considerable damage already has occurred. The FDIC estimates that losses to the Deposit Insurance Fund from these two bank closures will top $22 billion[1], mostly to cover uninsured deposits, which it intends to eventually recoup by raising insurance premiums. By early April, market jitters about the financial sector had dissipated and some banking pundits declared the worst of the storm to be over, though it seemed a bit premature to signal the all-clear. Then in late April, First Republic Bank announced deposit outflows of $70 billion in 1Q23, or 40% of its deposit base, far worse than analysts expected, as well as a major layoff announcement.[2] Its stock cratered 50% the next day.

Whether this fraught episode in the regional banking sector has passed or merely paused depends on understanding the precise causes of these bank failures and their prevalence elsewhere. There is compelling evidence, widely reported on in the business media, that the circumstances underlying these recent bank failures appear to be idiosyncratic, and their predicaments were not representative of other regional banks. Moreover, the fallout risk to the wider banking system or to the broader economy from these closures was contained by the decisive and timely actions of regulators.

Foremost, these banks primarily served a narrow base of clientele and had exceptionally high proportions of uninsured deposits due to their extensive relationships with wealthy clients and their businesses. In fact, SVB and SBNY had by far the largest percentage of uninsured deposits among regional banks covered by J.P. Morgan's sell-side banking team (**Figure 1**), with approximately 90% of their deposits uninsured, while First Republic Bank ranked third. Surely this is no coincidence. The high concentration of uninsured deposits made them especially vulnerable to large deposit outflows, as wealthy clients raced for the exits at the first whiff of smoke. Conversely, banks with a high percentage of insured deposits tend to have more stable deposit bases in challenging moments.

Bloomberg reported that on the day before SVB's collapse, legendary investor Peter Thiel had advised his Founders Fund and related portfolio companies to transfer funds from SVB following news that week of large investment losses and an unexpected capital raise effort,[3] with other notable Bay Area funds following suit once word had gotten out. Thiel's rationale was simple; there was no downside to such a move in the event his concerns were misplaced. In other words, better safe than sorry. Of course, such self-preservation tendencies by many large depositors will all but ensure that a bank failure does materialize. Similarly, SBNY reportedly experienced major deposit outflows on its last business weekday before regulators closed it on March 12th.[4]

Figure 1: Uninsured Deposits as a Percentage of Total Deposits



Source: J.P. Morgan, Regional Bank Handbook, March 2023

As it turned out, bank regulators decided to designate SVB and SBNY as systemically important institutions, a move that allowed the FDIC to fully protect all depositors' accounts, but this was an uncertain outcome as their fates hung in the balance. Nor is it a remedy that can be deployed widely across a domestic banking system with $17 trillion of deposits without an oppressive cost to banks and customers. Eventually, bank regulators and politicians will need to address the issue of deposit insurance policy, but there are no obvious solutions that can protect large depositors without imposing huge costs on the banking system. However, without changes to current deposit insurance coverage, the risk of disintermediation of uninsured deposits away from the banking system or from smaller community banks and regionals to money center banks remains ever-present and magnified.

Ironically, these bank failures had little to do with conventional reasons for banks going under, that being too many bad loans. Swift actions by the Fed and other regulators to resolve this mini crisis did little to address the larger issue at hand, which is the treatment of uninsured deposits at non-systemically important banks in the event of failure and the incentive it creates for uninsured depositors to avoid community and regional banks. This is not a new risk, but it was not a prominent concern until now given the unexpected and rapid deposit runs at SVB and SBNY.

The wider and lasting consequences of these events is that regional banks will remain disproportionately exposed to deposit outflows during moments of severe economic stress and will likely become more conservative in their business activities in the months ahead, reining in lending, maintaining more liquidity, and retaining more capital. This adjustment has already begun, with the Fed reporting that commercial lending activity decreased sharply in the last two weeks of March, especially at smaller banks. Such caution on a large scale would dampen business activity and increase the likelihood of recession. The wider impact of this story isn't over even in the absence of more bank failures.

Endnotes

[1] The Hill, "FDIC spent $20 billion to handle Silicon Valley Bank collapse," June 13, 2018.
[2] CNBC, "First Republic says deposits tumbled 40% to $104.5 billion in 1Q but have stabilized since," April 24, 2023.
[3] Bloomberg, "Founders Fund Advises Companies to Withdraw Money From SVB," March 9, 2023.
[4] Bloomberg, "Signature Bank Was Seized After "Crisis of Confidence," March 14, 2023.

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