The Banking Crisis: The Impact Beyond the Initial Failures

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Rising interest rates and deposit outflows trigger a banking crisis. Explore the implications on credit growth, the tightening cycle, and the economy.

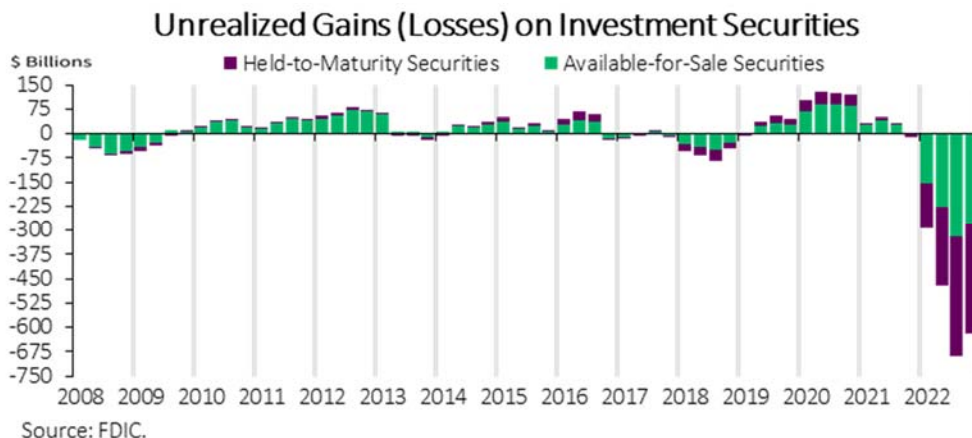
The recent banking crisis, starting with Silicon Valley Bank's collapse in early March, could have widespread impacts on the markets and economy. The Federal Reserve's efforts to combat inflation through monetary tightening over the past year have fueled the crisis. The Fed has raised short-term rates from 0% to 5% since March 2022. Simultaneously, it has engaged in quantitative tightening, reducing its balance sheet size by selling bonds acquired during the pandemic, which has led to an increase in long-term interest rates as well. The rapid rise in interest rates has created a dual crisis for many banks, with significant unrealized losses on investments and funding challenges as depositors move their cash to larger banks or higher-yielding money market funds.

While the crisis' immediate consequences include Silicon Valley Bank's collapse and First Republic Bank's turmoil, its longer-term economic effects could be more widespread. We believe three key aspects help understand this crisis and its broader implications: the dual crisis affecting regional and smaller banks, the impact on credit growth and the economy, and the implications for the monetary tightening cycle, interest rates, and equity markets.

The Dual Crisis:

As interest rates have moved higher, unrealized losses on bank balance sheets have ballooned to over $600 billion. When a bank classifies loans (e.g., mortgages or commercial loans) or bonds it has bought (e.g., Treasuries or agency mortgage-backed securities) as available-for-sale or held to maturity, the bank doesn't have to recognize losses as the value of the loans fluctuate with interest rates (loan values have an inverse relationship to interest rates). Concerns about unrealized losses initially sparked fears at Silicon Valley Bank and then First Republic Bank.[1]

The Banking Crisis: The Impact Beyond the Initial Failures



Under normal circumstances, unrealized losses on securities that a bank intends to hold until maturity are not an overwhelming concern. Due, in part, to stricter banking regulations in the aftermath of the 2008-2009 financial crises, banks are generally well-capitalized and maintain sufficient cash reserves to meet normal withdrawal requests. However, in the current environment, small and regional banks face growing withdrawals, possibly necessitating the liquidation of these investments to fund withdrawals and forcing these banks to realize losses. The realized losses could significantly impact the banks' financial stability or even their solvency. Customers with deposits exceeding the Federal Deposit Insurance Corporation's (FDIC) $250,000 insurance limit are understandably nervous and moving their funds into the larger banks that are deemed "too big to fail." There is over $17 trillion on deposit at more than 4,700 U.S. banks, and only about $10 trillion of the deposits are insured. Within the subset of regional and local banks supervised by the FDIC, up to $2 trillion of the $3.4 trillion of deposits are uninsured.[2] The migration of deposits from smaller to larger banks may persist, worsening liquidity pressures with no easy solution.

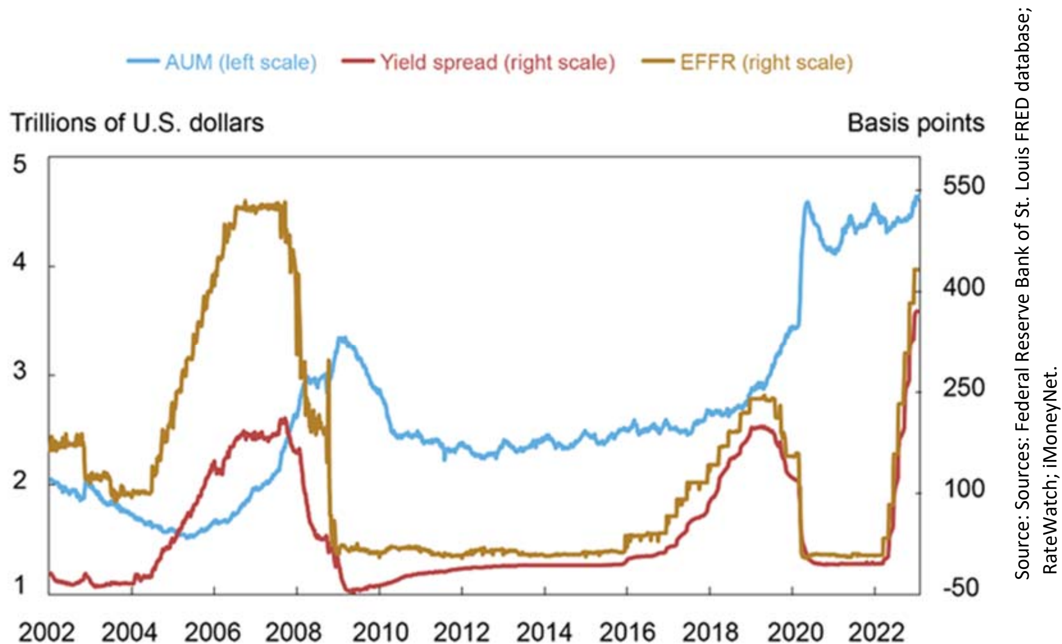
Compounding the issue is that banks are also losing deposits to money market funds at an accelerating rate. Due to the rapid rise in interest rates, many banks don't have the ability to offer meaningful deposit rates. These banks are holding loans and investments acquired when rates were low, which are now paying interest well below current market rates. During previous rate hike cycles, the slower pace of Fed increases allowed banks to adjust their balance sheet assets as interest rates continued to rise. They could invest in higher-yielding investments as lower-yielding ones matured.

The Banking Crisis: The Impact Beyond the Initial Failures

During this cycle, such readjustment has not been possible. Banks are struggling to attract or retain deposits with higher yields, as a significantly large portion of their assets remain locked into low-yielding loans and investments.

Fundamentally, bank earnings come from the difference between the interest rate the bank pays depositors and the one it earns on its loans and investments – banks can't offer deposit rates higher than what they are themselves earning. This situation risks creating a negative feedback loop, threatening bank solvency: low deposit rates lead to slow, or negative, deposit flows, which then result in fewer or no new loans at current rates; banks, lacking higher-yielding assets, keep deposit rates low, and the cycle repeats. While different than Silicon Valley Bank's 24-hour bank run, this slow and persistent deposit outflow creates a major headwind for many smaller and regional banks.

The following chart vividly illustrates this dynamic. Assets invested in money market funds (blue line) have reached record highs as the spread, or difference, between the interest rates banks are offering and what is available in money market funds (red line) is at multi-decade highs. Money market funds invest in short-term bonds and Treasuries that pay yields close to the current effective Fed Funds Rate (EFFR – orange line).

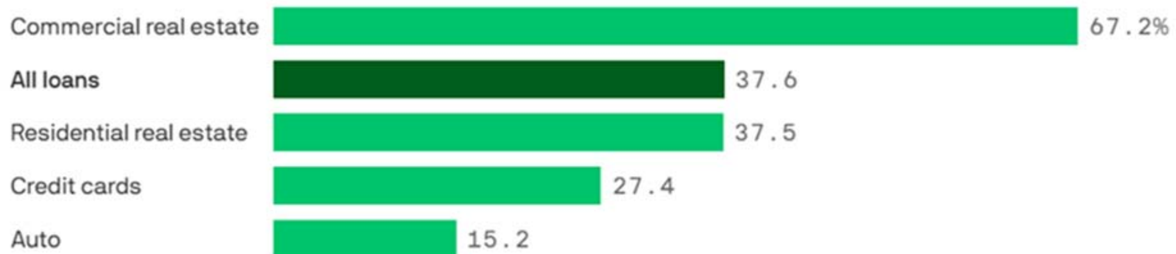


Source: Sources: Federal Reserve Bank of St. Louis FRED database; RateWatch; iMoneyNet.

The Banking Crisis: The Impact Beyond the Initial Failures

Credit Growth:

Small banks are the lifeblood of credit in several important areas of the economy, fueling the commercial real estate market (2/3 market share) and having a significant role in the residential real estate and credit card markets. Deposits fund loans, so when deposits migrate out of small banks, these banks will fund fewer loans.



When banks extend credit, they provide households and businesses with the necessary funds to invest in new projects, acquire capital goods, or finance consumption. This, in turn, drives economic activity and creates jobs. For example, a business may borrow money from a bank to purchase new machinery, which increases its production capacity and allows it to hire more workers. Similarly, a consumer may borrow money to buy a house or car, which stimulates demand in those industries. If small and regional banks keep experiencing deposit outflows, they will have fewer funds to lend. This could result in tighter credit conditions, with less lending by banks, and create ripple effects throughout the economy.

The Tightening Cycle:

The Fed's response to this crisis has been two-fold. On one hand, the Fed has introduced additional bank lending programs to reduce the stress on the banking system, such as allowing banks to borrow against some held-to-maturity securities without realizing losses. On the other hand, it now must contemplate how the crisis will impact its fight against inflation. In many ways, tightening credit

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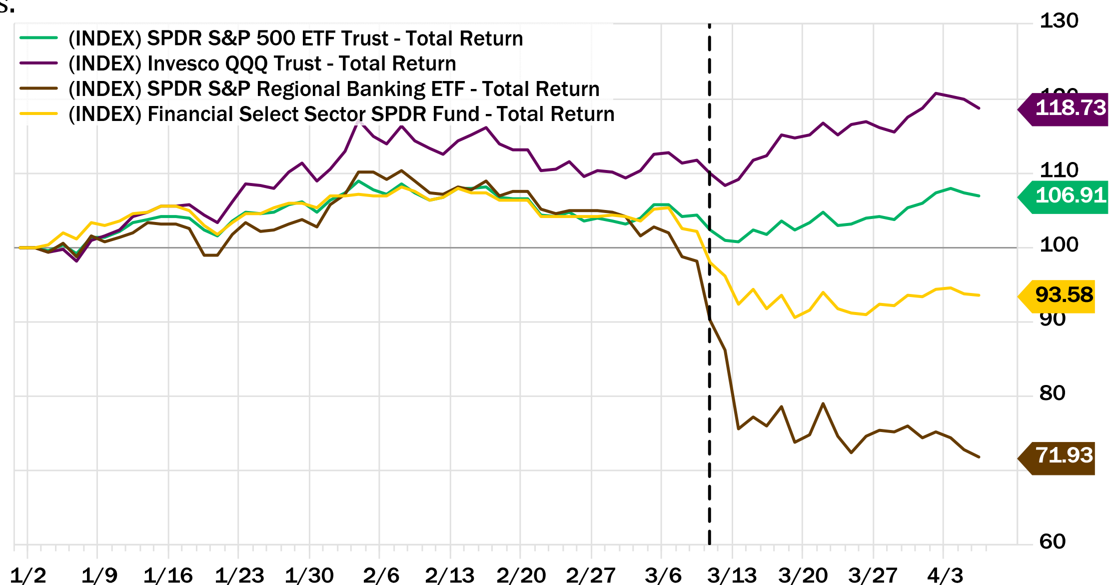
The Banking Crisis: The Impact Beyond the Initial Failures

conditions have a similar impact on the economy as the Fed raising interest rates. Federal Reserve Chairman Powell remarked at a recent press conference, "The events [banking crisis] of the last two weeks are likely to result in some tightening credit conditions for households and businesses and thereby weigh on demand, on the labor market, and on inflation. Such a tightening in financial conditions would work in the same direction as rate tightening."[3]

The market concurs with Chairman Powell's view and anticipates the imminent end of monetary tightening. Before the failure of Silicon Valley Bank, market implied probabilities indicated that the Fed would continue raising rates through the second quarter and hold them above 5% through year-end. However, the market now expects the Fed to begin cutting rates as early as the third quarter and finish the year with short-term rates at 4% – 1% below current levels.

Market and Economic Impact:

So far, it seems that the crisis is primarily affecting regional banks. The chart below shows the year-to-date performance of the S&P 500 (green line), the Nasdaq 100 Index (purple), the S&P 500 Financial Sector Index (yellow), and the S&P Regional Banking ETF (brown). After an initial decline at the beginning of the crisis (black dotted line), the S&P 500 and Nasdaq 100 have rallied as the market factors in the end of the tightening cycle and becomes more confident that the crisis will remain limited to regional banks.



The Banking Crisis: The Impact Beyond the Initial Failures

The economic impact will require more time to unravel. With the potential for tighter credit conditions, the Federal Reserve now faces another complication in its fight against inflation. If the Fed overtightens by continuing to raise rates, it could exacerbate problems within the banking sector, potentially leading to contagion in the broader economy. However, if the Fed eases monetary conditions too soon, inflation may again begin to increase. The Osborne Partners Investment Team will continue to monitor the evolving situation, ready to adjust to changing market conditions, with our style-agnostic, flexible investment strategy focused on risk vs reward. ■

[1] See our recent article "A Crisis of Confidence" for more detailed explanation of the origins of the banking crisis. https://osbornepartners.com/a-crisis-of-confidence/

[2] Federal Deposit Insurance Corporation, "FDIC Quarterly, 2023, Volume 17, Number 1," FDIC, March 16, 2023. https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2023-vol17-1/fdic-v17n1-4q2022.pdf

[3] Jerome Powell, FOMC press conference, Federal Reserve,
Washington, D.C., March 22, 2023, https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230322.pdf

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