First Republic Bank – "It WAS a Privilege to Serve You"

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An analysis of the bank's collapse, the implications for its clients, the ongoing risks to other banks, and the broader market and economic implications.

Early on the morning of May 1st, the FDIC seized First Republic Bank and subsequently sold it to JPMorgan Chase Bank. First Republic is the second largest bank failure in U.S. history and third bank failure since March. First Republic had been under pressure since the collapse of Silicon Valley Bank in early-March and the situation entered its terminal phase after First Republic reported earnings on April 24th.

Implications for First Republic clients:

JPMorgan Chase assumed all of First Republic's deposits (both insured and uninsured) and substantially all its loans and securities. Today, it is business as usual for First Republic Bank clients. Branches are open, and all aspects of client accounts, such as mortgages, lines of credit, direct deposit, ACH transactions (e.g., online bill pay, Schwab MoneyLink), checks, and debit cards, remain unchanged and continue to work as before. While account services remain unchanged, it is uncertain if JPMorgan Chase will maintain First Republic's renowned customer-centric service model.

A slightly different story, but same results as Silicon Valley Bank:

The underlying issues that doomed Silicon Valley Bank and First Republic Bank were the same – large unrealized losses on loans and investments, and a high percentage of uninsured deposits (balances above the FDIC's $250,000 insurance limit). Silicon Valley Bank failed due to a fast, social media fueled bank run among its highly concentrated customer base. After the demise of Silicon Valley Bank, concern shifted to First Republic because two thirds of its deposits were uninsured, and it had substantial unrealized losses in its held-to-maturity loans and investments.

Post earnings, a zombie bank:

The depths of First Republic Bank's problems became known when it reported first quarter earnings on April 24th. In the wake of the Silicon Valley Bank failure, nervous depositors withdrew over

$100 billion of deposits (56% of the 12/31/2022 total) from First Republic. To fund these withdrawals, First Republic relied on borrowings from the Federal Reserve and the Federal Home Loan Bank. The lost deposits, costing ~1% annually, were a far cheaper funding source compared to the new ~5% market-based interest rate borrowings.

While First Republic held over $170 billion in loans and investments that it theoretically could have sold to repay its borrowings, accounting rules rendered such sales impossible. First Republic had classified many of its loans and investments as held-to-maturity securities, which allowed the bank to avoid recognizing unrealized losses from interest rate fluctuations. However, selling any of these securities would require recognizing losses on all similar securities, which would have rendered the bank insolvent.

The problem for First Republic was straightforward but untenable: its loans and investments were earning the bank ~3.7%, while it was borrowing at ~5% to fund them. The reality that First Republic was in such dire straits spurred another post-earnings bank run that saw an additional $10 billion in outflows during the last week of April, leading to the bank's failure on May 1st.

Are more banks in danger?

After three of the largest bank failures in U.S. history, it is only natural to worry if more banks are at risk. Thankfully, the first quarter results of most regional banks have been positive – deposit losses were smaller than expected and earnings stronger than anticipated. Currently, it appears that most of the larger regional banks are on solid footing. Although additional failures among smaller banks are possible, we don't consider the issues affecting Silicon Valley and First Republic Banks as systemic risks to the economy. Moving forward, tighter lending standards will likely pose a greater challenge for economic growth.

Broader market implications:

We remain focused on the impact that deposit outflows from smaller and regional banks will have on credit creation and economic growth. Small banks play a crucial role in the economy, driving the commercial real estate market (2/3 market share) and significantly impacting residential real estate and credit card markets. Deposits fund loans, so when deposits migrate out of small banks, these banks will fund fewer loans.

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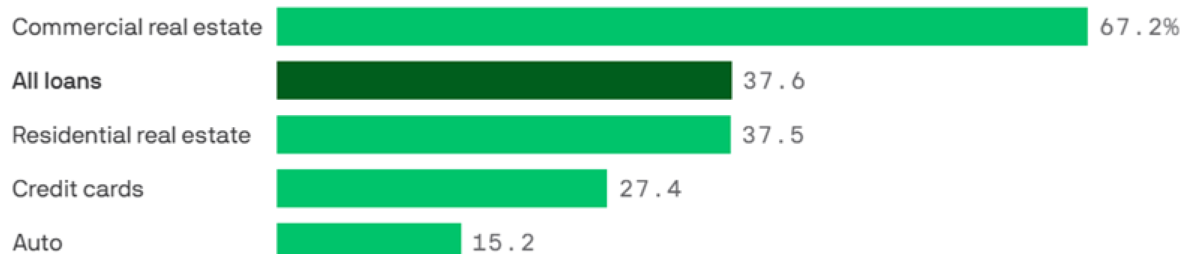

When banks extend credit, they provide households and businesses with the necessary funds to invest in new projects, acquire capital goods, or finance consumption. This, in turn, drives economic activity and creates jobs. For example, a business may borrow money from a bank to purchase new machinery, 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 way forward:

Two months into the crisis, the impact remains focused on 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 after Silicon Valley Bank filed (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 market reaction to the failure of First Republic Bank (green dotted line) has been modest.

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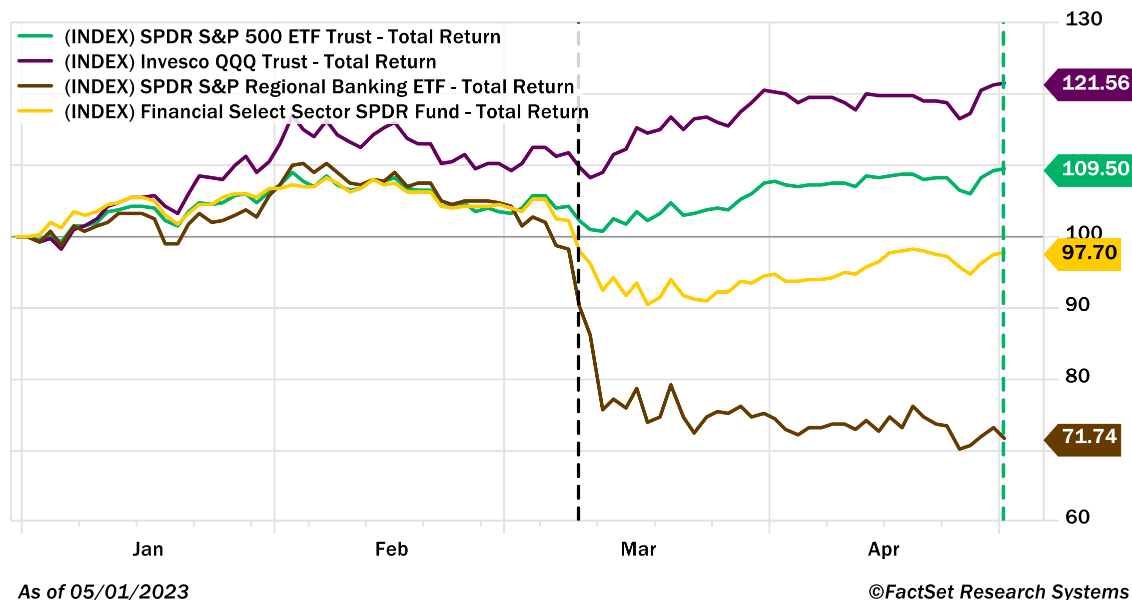

The economic impact will require more time to unravel. With the potential for tighter credit conditions, the Federal Reserve now faces another complication in its fight against inflation. If the Fed overtightens by continuing to raise rates, it could exacerbate problems within the banking sector, potentially 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 monitoring the situation and adapt to changing market conditions using our style-agnostic, flexible investment strategy focused on risk versus reward. ■

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