

WHAT HAPPENED TO THE US BANKING SECTOR IN MARCH 2023?

How rising interest rates resulted in the failure of three major US banks and caused many other institutions to reconsider their liquidity.

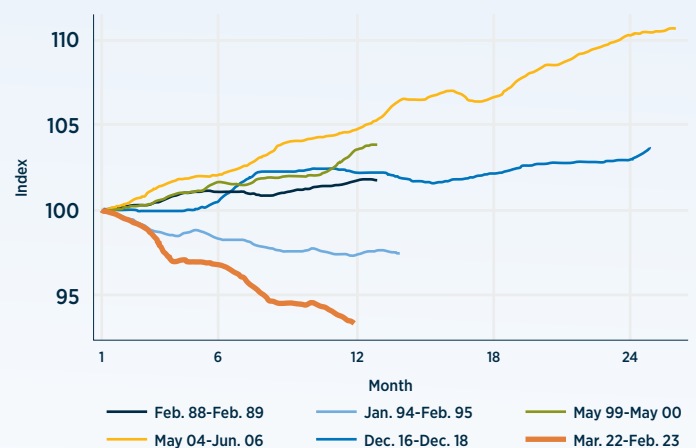
On March 10, 2023, Silicon Valley Bank (SVB)—a regional but large US-based bank with a decent-sized UK subsidiary—failed following a run on deposits. The run was triggered by a succession of interest rate hikes by central banks, which led to a drop in the valuation of bonds and other fixed income instruments held by the bank.

SVB's assets were comprised of longer-duration bonds bought when interest rates were low. As interest rate rose, those bonds lost market value. When rumors of SVB's weakening capital position leaked, there was a run on the bank, and selling these assets at market resulted in adjusted equity declining materially compared to reported equity.

Two days later, federal regulators shut down Signature Bank, after investors in the institution became concerned about its viability. Following the downfall of SVB, deposits in Signature started to leave the bank. Similar to SVB, some 90% of deposits were uninsured (i.e., the balances held were above the USD250,000 limit guaranteed by the FDIC). Combine that with the bank's ties to cryptocurrency and its exposure to private equity businesses (which had both experienced a downturn in confidence), and that was enough to convince investors to withdraw their deposits en masse.

While these two examples were at the extreme end of news events, more broadly it has become clear that bank deposits are falling faster than usual as policy rates rise.

Real Deposits Through a Hiking Cycle



Why is the loss of deposits faster now than it used to be?

No one knows for sure, but perhaps as customers are better informed, they became more sensitive to difference in returns. So, when deposit rates do not keep up with returns on other investments, like money market funds, people are quicker to withdraw from banks.

When the central bank raises policy interest rates, most other nominal interest rates in the economy rise with them. However, they do so at different speeds and in different amounts, and deposit rates across the board have stayed sticky.

Interest rates on deposits historically rise less than other nominal rates, and this hiking cycle has been no exception. In the UK and the Euro area, the average deposit rate across banks has increased by less than 50 basis points, despite the large hikes in policy rates. As a result, during hiking cycles it is natural for deposits in banks to either stagnate or to fall as a ratio of GDP.

In the US, other than the 2004-06 cycle—which took place against the background of a credit boom—in all other episodes, deposits stagnated. However, during the hiking cycle of the last year deposits leaving the banking sector were notable, totalling some USD312 billion in March alone.

Where did the deposits go?

So what happened to all those bank deposits, and where did the money end up? The numbers from the flow of funds in US financial markets provide a sharp account of what happened—at the same time as money flowed out of bank deposits, money market funds saw an influx of USD304 billion, strikingly almost the exact same amount that left commercial banks.

Within money market funds, it was those that invest in government securities and deposits at the Fed that saw almost all the increase. The money market funds deposited USD144 billion in the Federal Reserve (through the reverse repo facility). The Fed during this month, created new liquidity facilities for banks through which it lent USD148 billion to banks.

In short, approximately half of the deposits that left the banking sector re-entered the banking sector via the money market funds and the central bank. As for the other half, money market funds bought bonds issued by a special type of financial institution the Federal Home Loan Bank (FHLB) whose main line of business is to lend to regional banks. Therefore, one way or another, all of the money that left banks through deposits, re-entered through loans from the Federal Reserve or the FHLBs.

For the US banking sector as a whole, assets increased by USD135 billion during this month. One form of funding (deposits) was replaced by two others—Fed loans and wholesale funding—but the money flew right back into the banks.

Why does this matter?

It matters for three reasons: First, for banks, central bank and wholesale funding is considerably more expensive than deposit funding. Therefore, their profitability falls, which immediately affects their stock prices (as we saw in March). Moving forward, this should accelerate the trend towards concentration in the banking market.

Credit has held up until now, but localized crunches could be in the horizon. The graph below shows what has happened to loans again through a hiking cycle (again in constant prices and scaled by the size of the cycle). The current cycle does not stand out, and loans have kept growing. This illustrates again the decisive role of the Federal Reserve and the FHLBs in replacing deposit funding for banks. As of now, there is no sign of a generalized credit crunch.

Second, this leads to non-bank financial institutions being more susceptible to panics, since they do not have a central bank behind them. It also implies that there should be more natural trading of risk away from the more exposed institutions to the more protected ones. If the central bank replaces an important role of deposits in bank funding, this leads to a different equilibrium across financial markets, although it is hard to anticipate its features.

And third—and perhaps most prominently for (re)insurers, the muscled intervention of the Fed to keep banks' assets from failing is another indication of how active and interventionist central banks are in response to any liquidity problems. Yet, because central banks often find themselves legally limited to intervene only to assist commercial banks, this leaves other financial institutions less covered.

For many insurance companies, similar dynamics are at play. Policyholders can let their policies lapse to put their savings in higher-yielding investments. While this may not happen as fast and as aggressively as it does with banks, it will likely happen as the hiking cycle prolongs itself. Given the risks surrounding the path of interest rates discussed in the previous section, this is an important concern for reinsurance.

Immediately, a sharp increase in lapsed policies at insurance companies would not come with immediate emergency funding by the central bank and would trigger the sale of liquid assets realizing market losses, precisely what the Fed prevented happening in March with US banks.

Again, the case of SVB, as well as what happened with Signature Bank soon afterwards—and later Credit Suisse—illustrates this well. Central banks naturally protect banks, and this often means shifting losses to non-banks, as the holders of Credit Suisse bonds discovered. Life insurers should be particularly weary of a financial system where central banks are actively playing a role in the funding model of banks.

At the same time, as banks become less profitable, this should come, sooner or later, with an increase in the costs of bank loans. In the next couple of months, banks will experiment and discover the elasticity of loans to loan rates, and wither volume or the cost of bank credit will have to adjust.

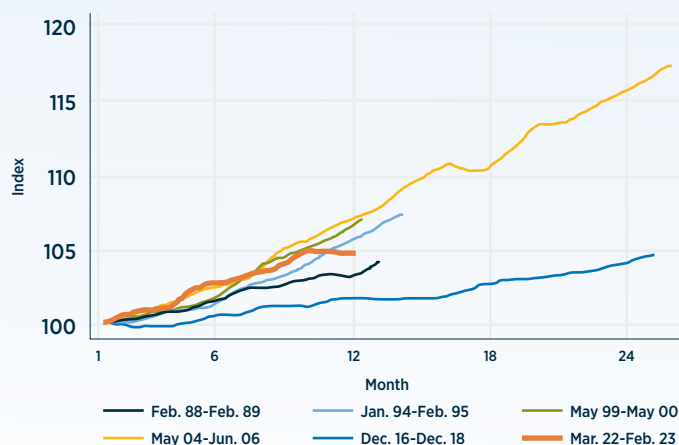
The process of reshuffling of funding described in the previous point will likely come with frictions and some institutions failing to replace their deposits as smoothly as others. This is especially the case in areas covered by regional banks, mostly the US, but also in some parts of the Euro area.

In that case, the more exposed banks are those that rely more on stable deposits for their lending. And these tend to be banks that are more devoted to business loans to the construction sector.

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This article is based on findings from research by Professor Ricardo Reis at the Centre for Macroeconomics at the London School of Economics. This research looked at the measurement of relative prices, the interpretation of differing expectations data, the measurement of inflation tail risks, the identification of changes in risk premia in bonds, the path for monetary policy given the trade-offs it faces, the trends in employment and output in the construction industry relative to their usual behavior, and the financial flow of funds. This was done to understand the likely behavior of inflation and short-term interest rates, and to lay out some of their risks and consequences for non-bank financial intermediaries.

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