April 2023

Commentary on the March Banking Events

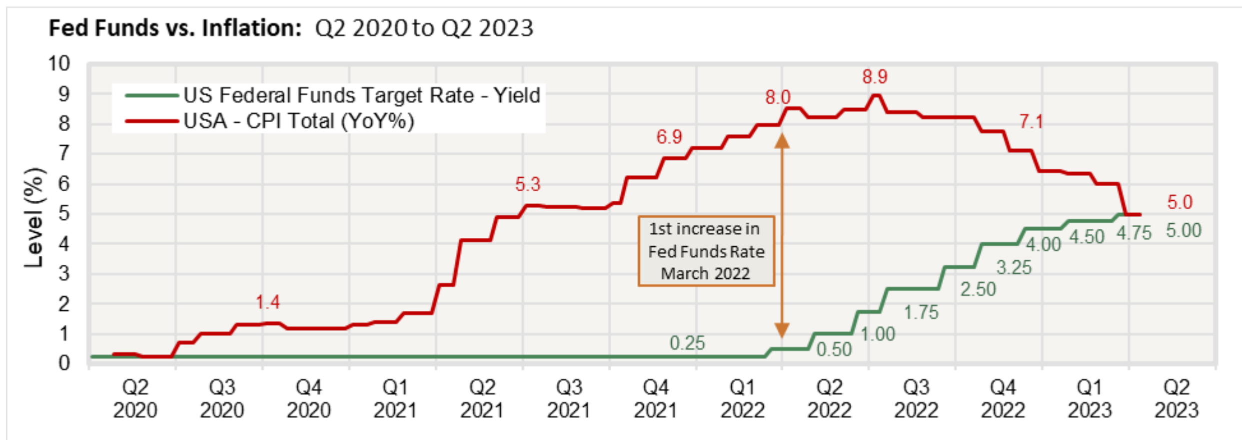
Banking and finance provide the means for any modern economy to grow. Banks supply capital for business to hire workers, obtain supplies, construct factories, and produce goods for sale to consumers. During certain periods, banking has also been a source of instability, as borrowing standards have slipped during every economic boom. Each boom usually ends with a slowdown, a recession, and market corrections.

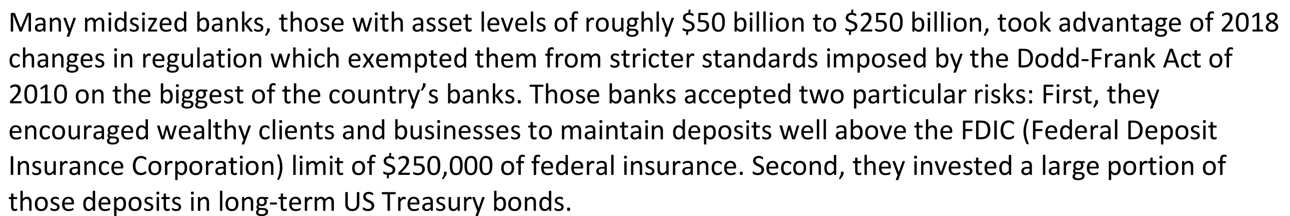
During March of this year the regional banking system fell under acute pressure. Despite declines in the banking sector, the broader market remained steadfast. While there are similarities to past market disruptions, the events that shook the banking system can be traced to factors not directly related to lower borrowing standards. However, they are clearly worth our attention and that of financial regulators. Listed below are several of the chief drivers:

1) Too much easy money for too long, beginning with the Great Financial Crisis (“GFC”) of 2008-09 and continuing with the COVID pandemic fears in 2020-21,
2) Belief that very low inflation and interest rates would persist even after economies reopened,
3) After no response to inflation rising to 7% in 2021, the Federal Reserve initiated an unprecedented 5% increase in short-term rates over eleven months, starting in March of 2022,
4) Unwillingness, on the part of a few bank managements, to take remedial steps to protect their balance sheets because of negative effects on profitability,
5) Unexpectedly rapid “run” on deposits of several banks that spread throughout the system and shocked the banking system, depositors, and investors.

The Federal Reserve was responsible for a very easy money policy, following the GFC, from 2009 into 2022. Interest rates remained at historically low levels, as economic growth remained modest, with virtually no inflationary pressures. The length of this policy lulled some businesses, bankers, and consumers into a belief that things would not change, despite warnings from the Fed that they would target a 2% inflation rate. As inflation escalated in 2021, the expected transitory inflation became more persistent, and the Fed pledged to do whatever it takes to curb inflation and return to its 2% target.

The Fed began its rapid increase in short-term rates in March of 2022, when inflation was just under 8%. With nine consecutive rate hikes, short-term rates rose from 0-0.25% to 4.75-5.0% in eleven months. The chart below shows the progression of short-term rates and inflation (“CPI”) over the last three years.





Many midsized banks, those with asset levels of roughly $50 billion to $250 billion, took advantage of 2018 changes in regulation which exempted them from stricter standards imposed by the Dodd-Frank Act of 2010 on the biggest of the country's banks. Those banks accepted two particular risks: First, they encouraged wealthy clients and businesses to maintain deposits well above the FDIC (Federal Deposit Insurance Corporation) limit of $250,000 of federal insurance. Second, they invested a large portion of those deposits in long-term US Treasury bonds.

While those bonds were AAA quality, they were bought when interest rates were very low. As rates rose, the value of these bonds fell. If depositors wanted their money back, the banks would be forced to sell the bonds at a loss. The only way to avoid that would be to hold sufficient short-term reserves available to meet unexpected deposit withdrawals.

But some bank managements preferred, over the past few years, to invest too much deposited cash in long term bonds, which earned more interest/profit than cash, until recently.

This turned out to be a major mistake. For when depositors at Silicon Valley Bank ("SVB") tried to withdraw significant amounts, the bank was forced both to sell securities at a loss and admit that the loss had an important negative effect on the bank's capital. SVB then announced it would raise additional capital and immediately depositors, most with deposit levels above the FDIC $250,000 insurance level, began pulling funds precipitating a run on the bank in just 24 hours.

A similar run occurred at Signature Bank ("SBNY") and then First Republic Bank ("FRC"), although the three institutions operated very differently. SVB was highly exposed to start-up companies and the technology sector. SBNY was exposed to the cryptocurrency sector. FRC was exposed to high-net-worth private clients.

The FDIC and the US Treasury immediately stepped in to contain the panic, by guaranteeing all deposits of SVB and subsequently SBNY. FRC received a deposit infusion from a group of larger banks, negating the need for FDIC intervention. The government's actions have calmed the banking ecosystem, and there have been no additional major outbreaks of panic in the last few weeks.

However, the events of March have exposed weaknesses in the current regulations of our banking system. Stricter and wider regulation, greater transparency of banking actions, improved oversight of executive stock trading, and higher guaranteed FDIC deposit levels are all now being considered. All of this will come with some cost to banking profit margins, but these are a small price to pay for a sounder financial infrastructure.

Over history the banking system has been an integral pathway for society to evolve, to reduce frictions in commerce, and for the economy to thrive. Adam Smith, the great Scottish economist of the mid-18th century, referred to the advantages of a banking industry during the Industrial Revolution, as a pathway for countries "to increase very considerably the produce of its land and labor". He also, presciently, drew attention to the risks present in banking, absent required conservative standards. The 2008 banking failures led to The Dodd-Frank Act, which introduced sweeping regulatory reforms in the banking system. While much more isolated and bank-specific, the events of March 2023 revealed risks to the system – some old and others new. Excessive risk-taking by management, insufficient regulatory oversight or foresight, and the speed at which information travels are lessons learned, again. We expect additional reforms to result, such as raising FDIC limits to align with inflation impacts since the last increase in 2008.

We hope that the lessons learned from this crisis contribute to a better and sounder financial industry.