BLOG

Bank Failures and the Fed

The failure of Silicon Valley Bank raises questions for Fed policy and economic growth.

BY **TIFFANY WILDING** | MARCH 14, 2023

One could consider the Federal Reserve's monetary tightening policy strategy as akin to the apologue of boiling a frog – or slowly turning up the heat until it's too late. Last week, during his semiannual Humphrey-Hawkins testimony, FOMC Chair Jerome Powell turned up the heat by signaling that the Fed could once again increase its fed funds overnight benchmark rate by 50 basis points (bps), and this coincided with a run on Silicon Valley Bank (SVB).

SVB was a midsize bank with heavy exposure to tech startups, including a large concentration of deposit funding through institutional deposit accounts, and significant unrealized losses on a portfolio of government and agency mortgage-backed securities, which it was forced to realize as it sold assets to fund deposit outflows. Unrealized losses on SVB's securities holdings were greater than its Common Equity Tier 1 capital, and depositors lost confidence in the bank's ability to repay its $175 billion in deposits (as of 31 Dec. 2022), the vast majority of which were not covered by FDIC insurance. As a result, depositors withdrew $42 billion in deposits last Thursday and on Friday the bank was taken over by California state regulators, who appointed the FDIC (Federal Deposit Insurance Corporation) as receiver.

The failure of SVB has contributed to a broader sell-off in bank equity share prices, especially those of other U.S. regional banks. We have to imagine that deposit outflows across all the regional banks over the ensuing hours and days after the SVB failure were enough for decisive action from policymakers to try to stem the contagion over the weekend. On Sunday the U.S. Treasury, FDIC, and Federal Reserve jointly announced that the FDIC would guarantee the deposits of SVB and Signature Bank – a separate bank that was having similar issues – and that the Fed would set up a new bank lending facility with very favorable lending terms to give banks some additional time to shore up their balance sheets. The Fed agreed to lend money to banks collateralized by their high quality asset holdings marked at par (not the current market value).

To be sure, SVB was in many respects a unique bank. Other similar-sized regional banks do not have similar concentrations of uninsured institutional investor deposits, which has meant that their "deposit betas" – the increase in the interest rate that they are forced to pay on deposits as the Fed raises rates – have been lower. They also don't have similar concentrations of unrealized losses in their securities portfolios relative to their Common Equity Tier 1 capital. As a result, if they are forced to sell securities to fund deposit outflows, they have larger capital buffers to weather any forced realization of losses. In addition, we view the large systemically important banks (U.S. SIBs) that must comply with the Dodd-Frank Act and are subject to regular liquidity and capital stress tests as financially sound and less vulnerable to a deposit run. In fact, several of the largest banks have been receiving net deposit inflows in recent days.

Nevertheless, these events can very well lead to a recession. Indeed, a 2008-like deleveraging event isn't essential for the economy to fall into recession. Slowing credit *growth* alone can be a meaningful headwind to GDP growth. Since economy-wide credit outstanding is a stock variable and GDP is a flow variable, it's the flow of credit that matters for GDP. Changes in the flow of credit – what economists call the credit impulse – are what matters for real GDP growth. There are very good reasons to believe that credit growth, which was already slowing, will slow more as a direct result of these recent events, despite the steps taken by government officials and the Fed.

First, regional banks, whose stock prices were down substantially at the time of this writing, are likely to be more risk averse, at least in the near term until the situation becomes clearer and the volatility subsides. Many of these banks are still at risk of deposit outflows to the larger banks. The FDIC announcements over the weekend importantly just guaranteed all unsecured deposits at SVB and Signature Bank; it did not guarantee all uninsured deposits across the banking system. The sheer size of an explicit guarantee of all uninsured deposits would take an act of Congress. Furthermore, according to the Fed, small banks make up around half of total domestic bank assets, a third of commercial and industrial loans outstanding, and half of real estate loans. It's hard to believe that these banks, fearing a potential abrupt deposit outflow, won't tighten their lending standards and slow credit origination as a direct result.

Second, and related, bank regulation for regionals has the potential to become more stringent. In 2018 a bill (S. 2155) was passed on a bipartisan basis that rolled back many of the Dodd-Frank requirements for smaller and midsize banks in terms of liquidity and capital. The regulatory rollback cannot be blamed for everything. The Fed had some leeway in specific implementation, and supervision probably played a role. As a result, the Fed is likely to tighten regulatory standards on the large regional banks where it can (specifically for those banks that have assets of more than

$100 billion), reducing their ability and willingness to make some of the riskier loans that larger banks who had to comply with Dodd-Frank did not want.

Third, assuming the policy response is enough to stabilize confidence and regional bank deposit bases in the near term, policies announced to date do not address the central issue that investors can get higher yields in a lower risk investment vehicle with a government securities money fund, which has access to the Fed's Reverse Repo Facility (RRP). Taking a step back, bank deposit rates have lagged the increase in the fed funds rate, making money fund investments higher yielding than bank deposits. However, increasing the interest paid on deposits isn't without costs. In the base case, it will lower net interest margin and contribute to equity share price volatility. In a worst case, increasing deposit rates could render some banks unprofitable, as they pay more for deposits than the yield they are getting on securities and loan holdings accumulated over the last two to three years. Some banks could try to defend their net interest margins by increasing the rate they charge on loans. Or if banks are price-takers in the loan market, they may have reduced appetite to make loans that are now less profitable for taking on the same credit risk. Either way, this should slow loan growth.

Fourth, even before this, bank credit standards were tightening and loan growth was slowing as a result of tighter monetary conditions. Monetary policy works through lags, and the lagged effects of the Fed's material financial conditions tightening last year were at the same time having a larger effect on the economy and financial conditions. What the SVB episode revealed was that the economy is, indeed, interest rate sensitive, and monetary policy conditions are indeed tight and having an effect on riskier segments of the market.

Fifth, with recession risks rising, it's hard to believe that there won't be implications for the broader private debt markets, including less money flowing into this space. A lot of financing left public markets in the last decade as tougher large-bank regulation made the business less attractive. Private debt markets have exploded as a percentage of GDP in recent years – going from roughly 5% of GDP in 2016 to roughly 10% now (around $2.5 trillion) – with economic and financial market linkages that are much more opaque. While the venture capital companies that held their operational deposits at SVB will be made whole to fund working capital needs, the event raises questions about the other kinds of risks that may be lurking in these markets. Most of the private market debt structures are floating rates with limited interest rate hedges, and tend to be used by companies that have elevated leverage and are more sensitive to economic cycles. While public financial markets may be dominated by large-market-capitalization companies, the small and medium-sized enterprises that tend to borrow from banks and in private markets dominate the real economy, accounting for about half of total U.S. employment.

What's the bottom line? Even though SVB had unique features that resulted in this revealed vulnerability, its failure will likely tighten financial conditions and slow lending growth despite government efforts to shore up confidence over the weekend. Banks in general may be well capitalized, but deposit runs are still a risk as banks must compete with money funds with higher yields and access to the Fed's RRP. As a result, it's difficult to imagine how banks won't tighten lending standards and slow loan growth. For economic growth and inflation, it is credit *growth* that matters for real growth.

All of this means the Fed needs to do less of the heavy lifting to get to the same result – tight financial conditions are slowing credit creation and will eventually slow inflation. As a result, the question is not whether the Fed hikes 50 bps or 25 bps at the March meeting. Rather it's, is the Fed's rate-hiking cycle over? Obviously this will depend on how fast and how much financial conditions tighten in the days and weeks ahead. With inflation high (despite slight easing in recent months) and labor markets strong, it's possible that government officials' response to the bank failures will smooth financial stability risks enough for the Fed to hike again next week. However, with policy already restrictive, credit growth likely to slow, and a potential recession looming, the frog may already have boiled.

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