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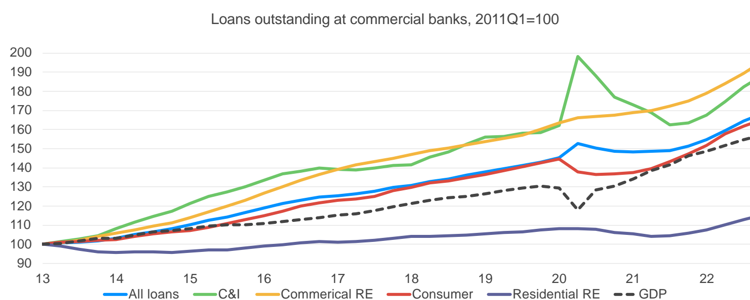
Financial System Shaken, Not Rattled

The bank crisis is unlikely to push the U.S. economy into recession.

- Recent U.S. bank failures are disconcerting to watch, but they are not symptomatic of a serious broader problem in the financial system.
- Policymakers' aggressive response should ensure the failures do not weaken the system or the fragile economy.

The failures of Silicon Valley Bank, Signature Bank and Silvergate Bank, with assets collectively of close to $325 billion, have roiled the financial system. Particularly disconcerting is the speed at which the institutions failed. Once depositors lost faith in the viability of these institutions and began withdrawing funds, the banks quickly unraveled. Bank runs are rare, but they happen at a dizzying pace when they do occur.

These failures were especially surprising on the heels of a lengthy period of calm in the banking system. There were no bank failures last year or the year before. The system has been enjoying solid loan growth, extraordinarily few credit problems, and healthy profitability. These are not the conditions that historically have been the fodder for problems in the system.



Indeed, it is unlikely that the recent bank failures are signaling more bank runs and failures are in train. The failed institutions were unusual in that they catered to the technology sector in the case of Silicon Valley Bank and the crypto markets in the cases of Signature and Silvergate. Of course, tech has been hit hard over the past year, beginning with the slide in the stock prices of most tech companies, and the crypto market has suffered something of a crash. There may be other banks with outsize exposure to tech and crypto, but if so, they are small.

Also unusual is that almost all of the depositors at Silicon Valley Bank had very large deposits that as such were not fully insured by the FDIC. Since the financial crisis, the deposit insurance limit has been $250,000. Many of the tech companies with these big deposits were quick to move their deposits out of the bank, sensitive to their risk. Compare this to the typical bank for whom well over half of deposits are below the FDIC limit and are generally very sticky. That is, depositors are slow to move their accounts, even for a better deal somewhere else.

Further containing any fallout from the bank failures on the rest of the banking system is that system's

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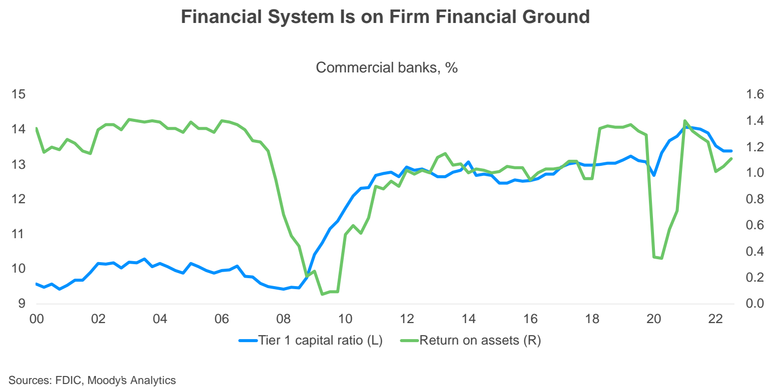
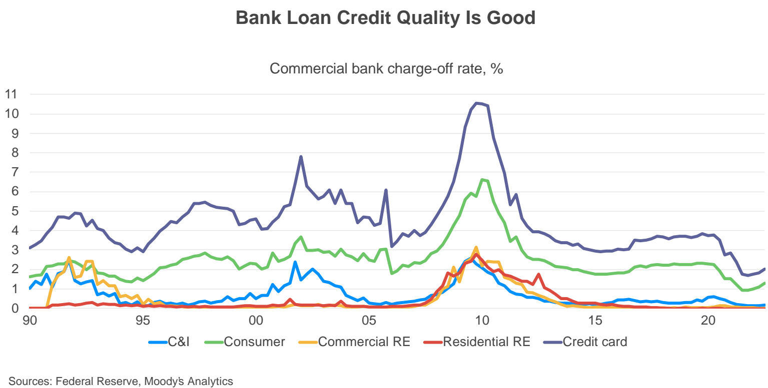
fundamental strength. In the wake of the financial crisis and reforms to the system, including the comprehensive Dodd-Frank legislation, the banking system has significantly increased its capitalization. The Tier 1 capital-to-asset ratio for the system has risen from less than 10% prior to the crisis to well over 13% today. The biggest banks must also engage in stress tests each year. These tests simulate the impact of severe economic downturns on their balance sheets and income statements. They are also often required to determine the impact on their financials of big swings in interest rates, although that was not part of this year's tests.



The banking system's strong financial performance is also not consistent with any significant problems. Loan growth has remained sturdy and consistent with the economy's growth, suggesting that underwriting has been generally prudent, and that leverage is manageable. Indeed, credit quality has been stellar with only a few pockets of developing concern. Delinquency and charge-off rates are rising, but this is simply a normalization after big declines during the pandemic due to the massive government support. Net interest margins—the difference between banks' lending rates and their cost of funds—are narrowing with the inverted yield curve (short-term rates are higher than long-term rates), but they are still ample. Taken altogether, banks remain profitable. The return on assets remains close to 1%, which is about as high as the ROA generally gets.



The liquidity of the system is also much improved, because banks now must hold a sufficient amount of their assets in cash or assets that can be quickly converted into cash to meet net cash outflows in a stressed environment. This liquidity coverage ratio requirement pertains to banks with more than $50 billion in assets, but only banks with more than $250 billion in assets must meet the most stringent version of the LCR. Of course, despite the system's enhanced liquidity, the failed banks seem to have had insufficient liquidity to meet their deposit withdrawals. Regulators will need to consider the LCR requirement in the context of recent events.

This highlights what appears to be the most significant vulnerability of the banking system, namely a classic asset-liability mismatch. Because of the surge in interest rates and the drawdown of bank deposits over the past year, many banks are struggling with how to meet depositors' demands. Smaller banks and credit unions are having the most difficulty and are responding by restraining their lending, selling Treasury and mortgage securities, and borrowing from the Federal Home Loan Banks—FHLB advances are quickly increasing. But having said this, these banks have mostly smaller depositors who are much less footloose and whose deposits are covered by FDIC insurance. They are steadily, but slowly drawing down their deposits, allowing for an

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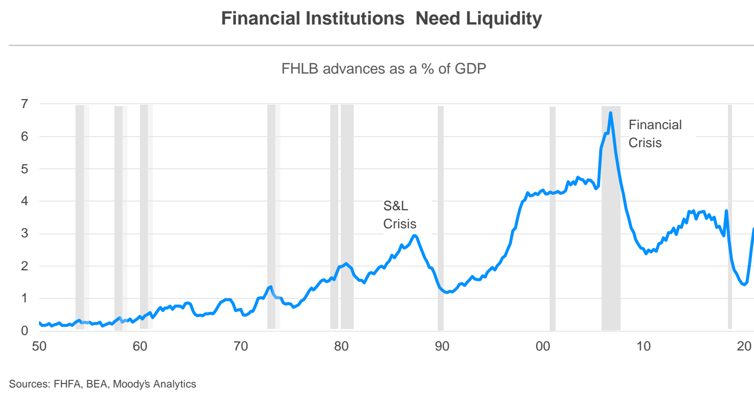
orderly adjustment by the banks.



Policymakers' aggressive response to the bank failures will also forestall them becoming a systemic threat. The Federal Reserve, Treasury and FDIC have determined the failures are a systemic risk and have thus invoked authority provided by the post-financial-crisis reforms to provide FDIC insurance to all depositors in the failed banks. This should allay depositors' fears about getting their money and end any bank runs. The Fed also stood up a new credit facility, the Bank Term Funding Program, a one-year facility that allows depositories to pledge qualified assets at par in exchange for advances at reasonably attractive rates. Treasury will use up to $25 billion from the Exchange Stabilization Fund to fund the creation the facility, which should meaningfully lessen liquidity needs of banks, at least in the near term.

Despite optimism that fallout on the financial system from the bank failures will be contained, they likely will impact monetary policy. The Fed will be under pressure to pause its rate hikes, and it is likely they will not raise rates at their March meeting. We had previously expected a quarter-point rate hike. So-called financial conditions are one of the factors used in Fed monetary policy decisions, and the current turmoil in the system will likely lead to a tightening in underwriting standards and less credit availability. The Fed will pause its rate hikes to gauge just how much conditions have tightened, and what the impact is on the economy and ultimately inflation. We now expect two more quarter-percentage-point rate hikes, 25 basis points each time, at the May and June meetings of the Federal Open Market Committee.

While highly uncertain given how quickly events are unfolding, the impact of the bank failures on the economic outlook should be on the margin. The economy will struggle this year and next and will remain vulnerable to events like those of the past several days, but this banking crisis is unlikely to push the economy into recession.

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