Research Institute - Insight

29 June 2023

8:29 minute read

#US / #Banking / #Growth

US banking stress: a slow squeeze instead of a hard stop

The US banking sector has stabilised, helping avoid a full-blown credit crunch. But the shock represents another headwind for bank lending and broader US activity. And risks have not dissipated for more vulnerable banks, or the sector as a whole.

Key Takeaways

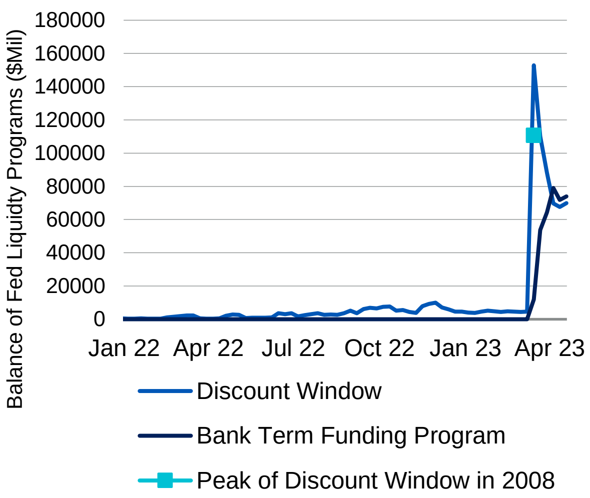
- A banking crisis hit in March, as a deposit flight forced some regional banks to crystalise losses on fixed income holdings, sparking bank runs.
- Policy action helped backstop the sector, but banks with large fixed income holdings, less sticky deposits, exposure to commercial real estate (CRE) lending and poor geographic diversification remain at risk.
- Policy support has stemmed deposit outflows, but these will continue as household savings are depleted and money market funds offer higher returns.
- Bank lending fell in March but has since stabilised. Scratching beneath the surface, corporate lending has been very weak, consistent with our pessimistic view on capex trends.
- We think banks have room to deliver only modest loan growth from now, especially against the backdrop of rising capital requirements. Lending capacity looks even weaker for those small regional banks important for small business and CRE lending.
- The crisis therefore acts as a further shock to credit supply, which, alongside rising interest rates, should act as a drag on growth, pushing the economy into recession around the turn of the year.
- But the shock has not been as severe as first feared, meaning the Fed has turned more hawkish recently as it sees downside risks recede somewhat.
- A re-acceleration in deposit flight could cause a full-blown credit crunch though, and a deeper recession.

Banking stress exploded in March, but has now eased

The US suffered a mini banking crisis as deposit outflows forced some institutions to realize significant losses on their fixed income portfolios, precipitating rapid runs on those names. In a matter of days Silicon Valley Bank and Signature Bank failed, while JP Morgan took over First Republic.

Concerns over a systemic crisis prompted equity declines and deposit flight across the sector, even at banks with more robust liquidity positions and asset portfolios. This led the Fed and Treasury to step in with measures aimed at easing fears over deposit instability and unrealized losses on fixed income assets.

Figure 1: Fed support measures supported confidence



Source: Haver, abrdn, June 2023

The Treasury controversially announced that deposit holders – even those in excess of the deposit insurance ceiling – would be fully protected during the resolution of SVB and Signature Bank, boosting confidence in the sector.

It also backstopped the establishment of the Fed's Bank Term Funding Program (BTFP), which allows banks to borrow from the Fed using Treasuries at par value as collateral, removing the need for potential fire sales of assets to cover deposit outflows. The same terms were offered to banks using the Fed's discount window, triggering significant take-up of both tools (see Figure 1).

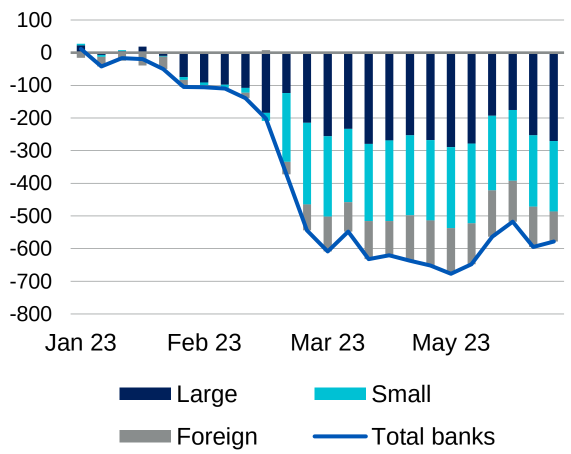
However, there are still a handful of risk factors that warrant close attention at individual banks, especially if economic conditions worsen. These include banks with:

- A combination of longer duration securities and the asset mix tilted towards held-to-maturity securities, which are vulnerable to loss should they be marked prematurely to market given the current level of interest rates;
- Deposit bases that are heavily concentrated, with overweight towards commercial customers and large uninsured components;
- Significant exposure to CRE lending given concerns over asset quality;
- Poor geographic diversification.

Deposit flood slows to a trickle

Deposits started flowing out of US banks last year, amid rising rates on alternative savings products and shrinking excess household saving balances. This outflow accelerated sharply in March as concerns over bank solvency exploded. The sector has lost 3.4% of its deposit base over 2023 thus far, with this drain concentrated in small banks (-4%) and foreign banks (-9%). Large banks have performed better (-2.3% year over year) helped by some flight-to-quality flows from smaller and riskier names.

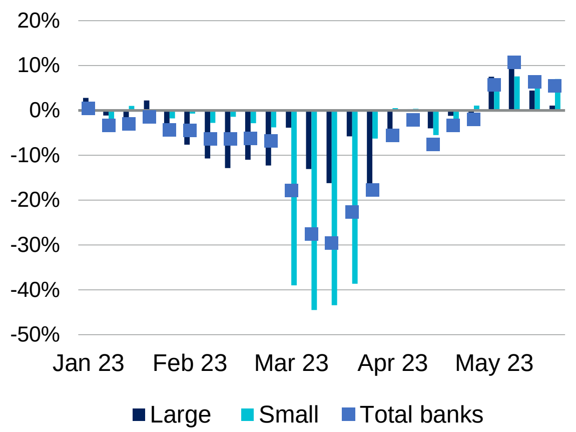
Figure 2: Cumulative change in deposits at US banks



Source: Haver, abrdn, June 2023

However, we have seen deposit trends stabilise before turning higher as money moves tentatively back into the sector (see Figure 3). Again, large banks have been clearly outperforming their smaller peers in attracting new deposits.

Figure 3: Change in deposits at US banks (1m annualised)



Source: Haver, abrdn, June 2023

This encouraging trend may signal that some of the worst fears around bank runs and a systemic crisis have eased. Still, headwinds to deposit balances remain – high yields available on money market funds and further declines in household saving balances – and bank analysts expect low single-digit deposit outflows.

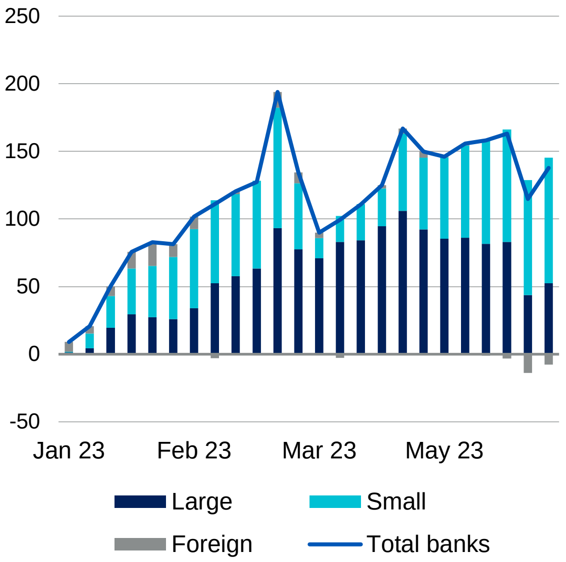
There is a risk of a renewed acceleration in deposit flight if concerns over bank vulnerabilities build again. And even absent a large system-wide shock, we could see an environment of "have and have nots" emerge as large institutions are viewed as more stable than smaller regional banks with the characteristics we flagged earlier.

March shock hit lending, with a small recovery since

Loan growth last year was strong, at 11.5% across the sector as a whole, however, adjusted for inflation, this drops to 4.5%. Year-to-date we are up a much slower 2.2% annualised in 2023, and, adjusted for inflation, lending has actually contracted by 2% in real terms.

Much of the lending activity took place before SVB's collapse with banks clearly pulling back in spring (see Figure 4) because of funding pressures and equity declines, but we have since seen a modest rebound.

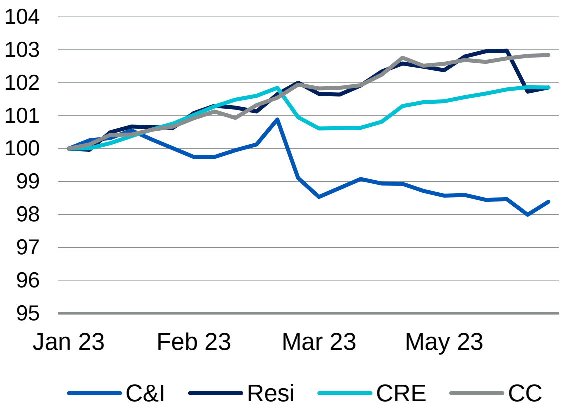
Figure 4: Cumulative change in bank lending



Source: Haver, abrdn, June 2023

This has been driven by stronger residential lending and consumer credit growth. In contrast Commercial & Industrial (C&I) lending has been extremely weak through the year and particularly after March, and so has, albeit to a lesser extent, CRE activity (see Figure 5).

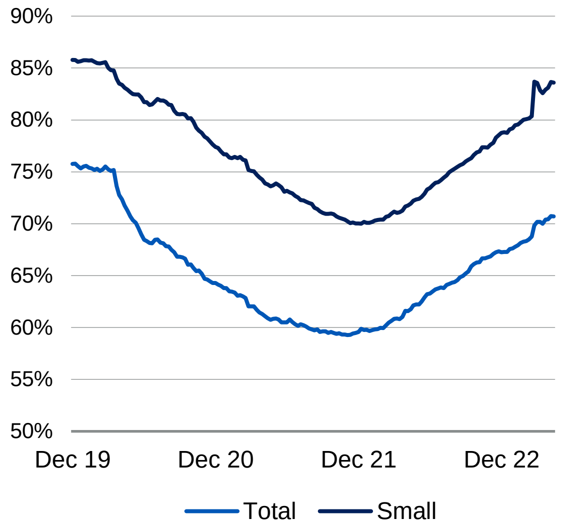
Figure 5: US bank loan balances by category (rebased)



Source: Haver, abrdn, June 2023

Banks typically use deposits to fund their lending to households and corporates. The combination of shrinking deposits and steadier loan books means that the loan-to-deposit ratio for all banks in the US has increased to 71%, up from a low of 59%, but still somewhat below the pre-pandemic level of 75% (see Figure 6). The increase has been even sharper for small banks, which have loan portfolios amounting to 84% of their deposits, up from 70% and only a shade below pre-pandemic levels (86%). An increasing ratio might tell us that bank liquidity positions are deteriorating, meaning they are less able to accommodate loan losses or deposit flight, and may have less capacity to expand their lending.

Figure 6: Loan-to-deposit ratios for US banks



Source: Haver, abrdn, June 2023

Lending growth is likely to be subdued this year

Even without banking stress, we were anticipating weak loan growth this year as interest rates rise and economic uncertainty builds. Moreover, the sector is facing rising Total Loss-Absorbing Capacity (TLAC) requirements, which could further weigh on lending capacity (see Box 2).

Box 1

Pressure to raise capital is another headwind

The banking industry was already anticipating the impact of the new TLAC requirements proposed in October 2022 by the Fed/FDIC. These will require Category II and Category III banks to maintain an additional buffer of debt and capital that can help in a crisis if needed. As a result, the industry is expecting larger banks ('Big 6' and regional banks with more than $250bn of assets) to issue incremental debt over the next few years. From a capital perspective it is possible that banks are more cautious around lending, to limit the need for additional loss-absorbing capital.

The deterioration in capital positions across several banks seen this year exacerbates the need for additional debt issuance and capital raising to satisfy TLAC requirements. It also will make it harder to improve these capital positions organically via retained earnings. While the adjustment to higher TLAC rules will be a multi-year process (likely through 2025), markets are preparing for a gradual repricing. In addition, the scrutiny from regulators post-SVB has increased the probability that these requirements trickle down to the $100-250bn asset category (Category IV banks) where capital shortfalls may exist.

How much might the recent stress and ongoing deposit flight add to these macro headwinds? The good news is that we do not seem to be on the verge of a credit crunch.

Indeed, according to our calculations, banks would be able to deliver low but still positive rates of loan growth between 3% and 5% in the case of continued modest (1%-3%) deposit outflows, and a rise in loan-to-deposit ratios (LDR) back to pre-pandemic levels (see Figure 7).

Figure 7: Expected change in bank lending under various deposit outflow and loan-to-deposit ratio targets for US banks

LDR target	Deposit outflow 1%	2%	3%	5%	10%
71%	-0.3%	-1.3%	-2.3%	-4.3%	-9.3%
72%	1.1%	0.1%	-0.9%	-2.9%	-8.1%
73%	2.5%	1.5%	0.5%	-1.6%	-6.8%
74%	4.0%	2.9%	1.9%	-0.2%	-5.5%
75%	5.4%	4.3%	3.2%	1.1%	-4.2%

Source: Haver, abrdn, June 2023

When we rerun this analysis for smaller banks, we see that their lending capacity is capped between 1% and 3% given their weaker deposit bases. This highlights the challenges that smaller businesses dependent on these institutions might face in securing finance.

Clearly, these dynamics would worsen should stress re-escalate, with a more rapid deposit flight. A 5%-10% drop in deposits over the next 12 months would see lending drop around 0% - 5% in nominal terms based on our calculations, even if accompanied by a rising LDR. For context, loans dropped 8% at their peak during the financial crisis.

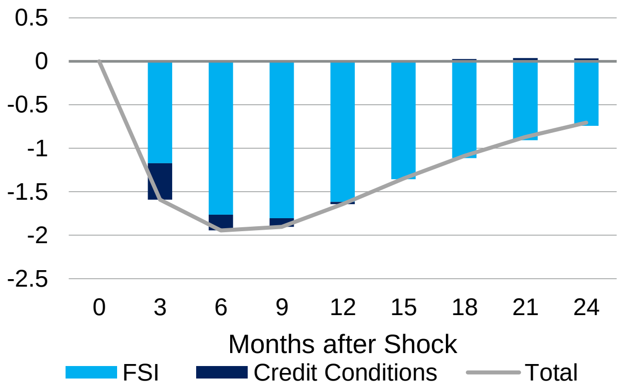
Feedthrough of lending to real activity

Bank lending is a critical source of funding for capex (particularly for small firms), investment in residential and commercial real estate and durable goods spending on items like autos.

As flagged, the tightening in monetary and financial conditions seen most acutely through last year would typically be expected to weigh on lending for these activities within 12-18 months. But we can try and estimate how the additional tightening in credit conditions in the wake of banking stress could exacerbate these headwinds.

To do so, we summarize the signal across the Senior Loan Officers Opinion Survey (SLOOS) into a single series, to measure US credit conditions. This tightened further after the banking turmoil this year. Our modelling suggests this tightening in credit conditions presents a clear drag on US GDP growth in the 12 months after the shock. This adds to the already significant headwinds coming from monetary policy tightening, proxied by our financial stress index.

Figure 7: Modelled impact of credit conditions and monetary policy tightening on US GDP



Source: Haver, abrdn, June 2023

Final thoughts

While we are not in the middle of a deep credit crunch following this year's banking stress, we should not be complacent. Some banks remain vulnerable, and the system will need to grapple with higher capital requirements. Short-term deposit and loan data should be monitored for signs of renewed tensions.

Alongside higher rates, tighter credit conditions and weak loan demand, this is another headwind to the already weak credit impulse. This adds to the Fed's policy tightening and we expect a recession at the turn of the year.

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