Investment Team Corner

In conversation with Lead Banking Analyst Michael Hutchens, CFA

Investment Team Corner: Michael Hutchens, CFA (Senior Analyst on the Financial Institutions Research Team)

The U.S. banking sector has a been a "hot topic" lately, generating significant attention and investor concern after highly public financial institution failures and takeovers by direction of the regulators. We interviewed Michael Hutchens, our senior analyst on the financial institutions research team to get his insights into these developments and their significance for Brandes' investors. Mike has 29 years of industry experience, including 21 years with Brandes.

Mike, dramatic collapses and takeovers have overshadowed the U.S. banking sector recently, causing a loss of confidence in certain banks. Is this situation identical to the global financial crisis (GFC)?

Based on my experience during the GFC, I believe today's situation is very different. Policymakers and the industry responded to the GFC by making the system more resilient and imposed stricter capital requirements. U.S. banks have about three times the capital levels today versus before the GFC. Underwriting standards were also significantly tighter prior to this crisis than they were prior to the GFC. Banks simply have less risk in their loan portfolios. The riskiest exposures—particularly commercial real estate, i.e., office properties, leverage loans—are at what we consider manageable levels for the system as a whole. Previously, the sector's exposure to subprime mortgages and subprime securities was of a different magnitude, particularly in relation to capital.

Even if today's situation does not closely resemble the global financial crisis, what caused today's banking disruption?

It started with the massive fiscal and monetary stimulus response to the pandemic. Commercial bank deposits increased 27% from March of 2020 to March of 2021, creating about $2.5-to-$3 trillion in surge deposits. The Fed had effectively cut interest rates to zero; the long-term treasury yield was below 1% for most of 2020 and well below 2% for most of 2021. The choices to redeploy those funds weren't optimal. You could deposit excess cash at the Fed reserve and lose money when deposit insurance is included. Or you could invest, but you required duration to achieve any meaningful spread. The three banks the FDIC has seized had particularly robust deposit growth. From March 2020 to March 2022, First Republic grew deposits by 73%, Signature Bank by 188%, and SVB by 220%.

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Many of those excess deposits went into longer duration assets and securities. First Republic opted for fixed-rate or hybrid-rate jumbo loans. This created an asset-liability mismatch. It also caused capital treatment issues: once the Fed started raising rates aggressively, much of these assets lost significant value. But that wasn't reflected in capital adequacy ratios because banks with assets under $700 billion aren't required to incorporate unrealized losses on their available-for-sale securities portfolios. It's fine if you don't have to sell those securities to fund deposit outflows. But that's exactly what happened, followed by fear and deposit runs. Today, technology adoption —particularly mobile banking — is much higher, so money moves much quicker. And social media usage is much higher than it was during the GFC. So, those are two significant risk factors that weren't as prominent before. Their impact resulted in the historic pace of deposit outflows compared to those of the past.

So, today's banking failures originated with COVID-19 "easy money" pumped into the financial system to keep it functioning. But that strategy occurred worldwide. Why were these institutional failures more of a U.S. phenomenon?

When you compare U.S. money supply creation against many other advanced economies, you find growth elsewhere, but it's significantly less. You didn't have the same level of surge deposits that occurred in the U.S. There was also a more measured pace of interest rate increases where they happened at all. In the U.S., a lot of the outflows go to money market funds and short-term treasuries. Right now, a short-term treasury is yielding above 5%. That's tough to beat with a bank product, particularly in states with state income tax as interest on treasury securities is exempt from state income tax.

So it's partly a consequence of the regulatory approaches taken by different governments, but it's also maybe different regulations. Are distinctions in regulatory scrutiny based on size of assets a factor?

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Yes. The U.S. made a policy decision to have a lower regulatory burden for banks in the $100–$700 billion asset category than applies in other developed jurisdictions, especially the Eurozone. "Lighter touch" regulation imposes a lighter burden but also creates vulnerabilities. Banks comparable to SVB, First Republic Bank or Signature Bank would be regulated very differently by the European Central Bank (ECB) as capital and liquidity requirements very similar to those regulating Europe's largest banks would be applied. In the U.S., most banks within this tier were not held to higher liquidity requirements. Capital requirements were also different, particularly in not recognizing unrealized losses on available-for-sale securities. The U.S. policy choice has pluses and minuses, but has caused added stresses on a segment of U.S. banks.

How would you compare the three bank failures with previous bank failures, for example those during the global financial crisis and other periods? Also, how do you think this turmoil may change the regulatory landscape for U.S. banks going forward?

To find similarities with past crises, you have to look beyond the GFC, namely at the savings and loan (S&L) crisis in the 1980s and 1990s because the S&L failures were also largely an asset-liability mismatch. Funding too many long-term assets with short-term deposits caused the cost of those deposits to increase significantly. Capital levels or asset quality were very good at all three banks affected by recent events. They all met or exceeded capital requirements, but there was a crisis of confidence due to system vulnerabilities.

It's not rational to prompt a bank run. But once it's on, it's rational to participate—particularly if you have a significant amount of money in uninsured deposits. In the three bank failures, much of the deposit base was uninsured, again reflecting government and FDIC policy choices. So, should FDIC insurance expand to cover certain depositor categories, like businesses that rely on accounts for payments or working capital? The government must decide how to regain confidence in the mid-size, regional banking system. That's where we're at now. We seem to be beyond the panic phase, but many of these banks are still overexposed to some economic sectors— like office real estate — that are particularly challenged. I think going forward, we'll likely have meaningful increases in the regulatory burden for many banks in the $100–$700 billion grouping.

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