MAYFAIR
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Reviewing the Recent Bank Failures

The banking industry is experiencing a crisis of confidence as checking deposits are withdrawn after businesses and individuals flooded banks with new deposits during the pandemic. Figure 1 shows deposits at commercial banks rose from $13.2 trillion at the end of 2019 to a peak of $18.1 trillion in the first half of 2022. The increase in deposits occurred as the Federal Reserve grew its balance sheet by $4.5 trillion, the federal government distributed multiple rounds of stimulus checks, and social distancing restrictions limited consumer spending on services. More recently, Figure 2 shows deposits at commercial banks decreased in 9 of the last 12 months. The decline in deposits is occurring as the Federal Reserve shrinks its balance sheet and inflation weighs on consumer savings. Banks complained about too many deposits in the past few years, but now declining deposits are starting to pressure some bank balance sheets.

Last week saw the failure of two California banks and one New York bank serving niche industries that benefited from the recent period of 0% interest rates. Silvergate and Signature Bank operated as bankers to the crypto industry, and Silicon Valley Bank (SVB) catered to the venture capital and startup ecosystem. All three banks experienced a surge in deposits during the pandemic for industry-specific reasons. Silvergate and Signature Bank took in deposits from crypto exchanges and other industry participants that lacked access to banks due to regulatory constraints. SVB's deposits grew rapidly as startups raised money from venture capital firms and parked it at the bank.

Bank analysts point to the three banks' business models and lack of diversification as the cause of their issues. From a business model standpoint, the banks quickly took in a surge of deposits. Instead of using those deposits to make new loans to consumers and businesses, the banks purchased U.S. Treasury bonds and agency mortgage-backed securities with relatively long maturities. The banks primarily purchased bonds with long maturities because the bonds offered significantly more interest income than short maturity bonds, which offered relatively low income due to the Federal Reserve keeping interest rates near 0% during the pandemic. The risk for the banks was that the Federal Reserve increased interest rates and the bonds lost value, which is exactly what happened.

Fast forward to the start of 2023, the three banks experienced a flood of withdrawal requests. To meet the deposit withdrawal requests, the banks were forced to sell assets, including the Treasury bonds and mortgage-backed bonds the banks bought when interest rates were lower. The problem for the three banks is interest rates are significantly higher than when the banks bought the bonds, which resulted in the banks realizing billions of dollars of losses. The realized losses drained the banks' capital cushions, making the banks technically insolvent. Silvergate voluntarily ceased operations and plans to liquidate its assets, while Signature Bank and SVB were both taken over by the FDIC.

The three bank failures are a unique situation, because the banks did not have bad assets in the form of risky loans or complex derivatives. To the contrary, the banks primarily held safe assets in the form of U.S. treasuries and mortgage-backed bonds. The banks' undoing appears to be related to a mismatch between their liabilities (which were the concentrated deposits from niche industries) and their assets (which were

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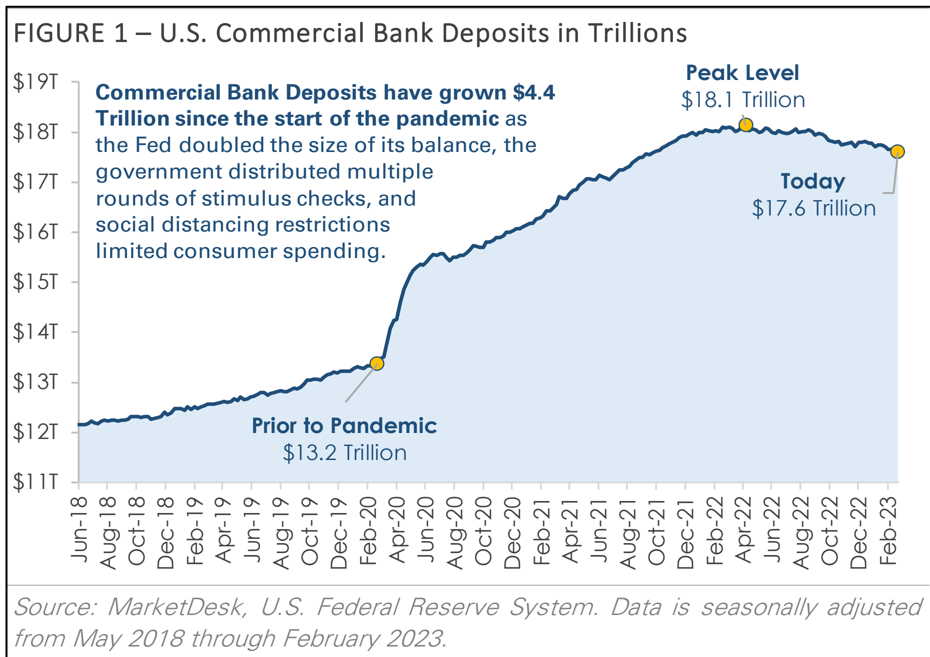
the bonds with long maturities). In our view, the lesson from the three bank failures is not that banks are sitting on risky loans and complex derivatives but rather that aggressively raising interest rates from 0% to above 4% stressed the banks balance sheets and could stress the wider financial system.

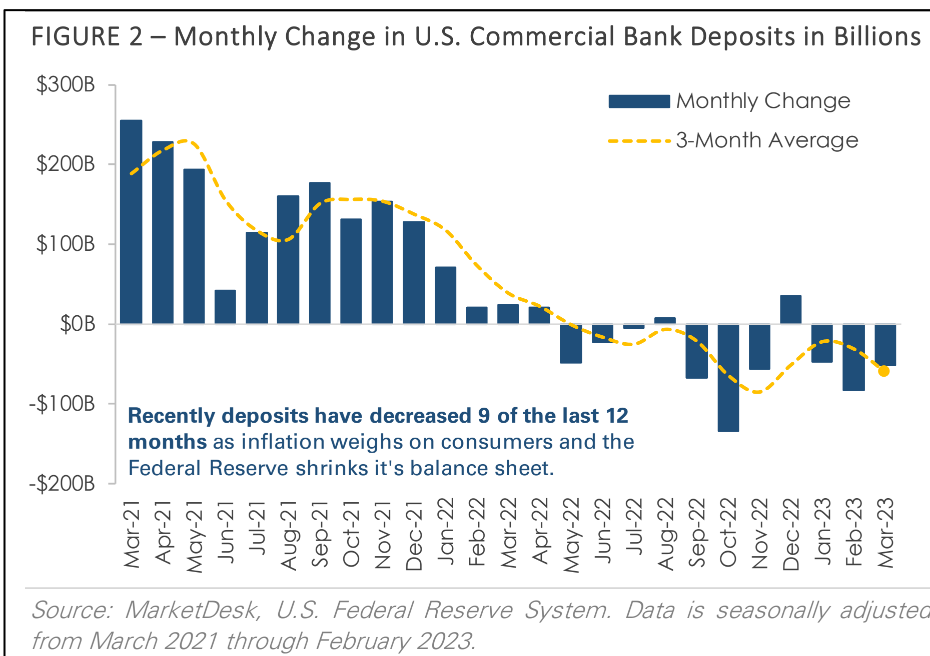
While the banks' failures are concerning, it is important to note bank analysts believe this is a unique situation due to specific client bases and their balance sheets. Although other banks could face similar isolated issues, analysts believe most banks managed and matched their assets and liabilities better than the three banks that failed. However, investors, the Federal Reserve, and regulators will be watching for signs of stress across the financial system this year.

FIGURE 1 – U.S. Commercial Bank Deposits in Trillions



Source: MarketDesk, U.S. Federal Reserve System. Data is seasonally adjusted from May 2018 through February 2023.

FIGURE 2 – Monthly Change in U.S. Commercial Bank Deposits in Billions



Source: MarketDesk, U.S. Federal Reserve System. Data is seasonally adjusted from March 2021 through February 2023.

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