# Getting Past the Panic: Mend capital availability, then capital costs

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IN A NUTSHELL

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## Panic of '23: It's hard to put a probability on panic, when it happens risk lingers

The US regional bank panic of 2023 is a significant event with long lasting implications. Like past panics, this one will pass too. But with consequences, lessons and changes for banks, the system, regulation and investors. Some of the issues at hand are centuries old. Even with whatever new changes come, or reversions to old practices, banking will remain risky. How this risk is managed (selected, buffered, distributed and compensated) is crucial to a well-functioning and high productivity economy. How the many private and public players react to this episode will affect US growth and inflation the rest of this decade. It's important to find the right tools and the right balance of policy. It's important to get this right.

## US Banks are Safe & Sound: Let's also keep them diverse and energized

US banks are a sound store of wealth. In this note, we present concepts and data on how to evaluate the safety of bank deposits. Securing safety of deposits is the solemn duty of bank managers, regulators and system supporting institutions. But we want banks to be more than vaults. We want a diverse banking system with the ability and resources to gather and efficiently deploy capital. We're champions of capital markets, but we also see US regional and community banks as a powerful engine of US investment at local levels. We think it very important that the U.S. Federal Reserve (Fed) do all it can to support its member banks against the risks of panic and the restrictive interest rates it's pursuing to help fight inflation. In our opinion, the Fed should and can provide all necessary support and it's not needed or preferred that Congress guarantee deposits of any size outside of national emergency.

## Federal Reserve Act of 1913: Member Owned Federal Reserve Regional Banks

The government is key in regulating and ensuring confidence in a strong banking system. But the banking system has its own institutions to help provide it support in times of need. The Federal Reserve System includes 12 Regional Reserve Banks. These Reserve Banks are owned (albeit not controlled) by member banks. Among the many responsibilities of the Regional Banks is to be lender of last resort. Each Reserve Bank operates a Discount Window. The Discount Rate is set by Regional Banks with Board of Governors approval; not the Federal Open Market Committee (FOMC), which sets the Federal Funds rate. We believe the FOMC should manage its dual mandate with the Fed Funds rate and the Reserve System should support its member banks with a temporarily lower Discount Rate than the Fed Funds rate.

This would allow smaller banks to orderly adjust deposit pricing and asset yields over time. Liquidity buys time, time enhances bank strength and non-penalty interest cost liquidity is quicker.

## Deposit's Lines of Defense: 1) Bank profits, 2) Loss reserves, 3) Equity, 4) FDIC

Safety of deposits in US banks is very high. Pre credit cost profitability at US banks is high owing to higher interest rates. Assets held by US banks are high quality, including government and highest grade fixed income securities and high quality loans. Healthy asset/equity ratios, show these assets exceed liabilities (including bank debt and other loss absorbing capital). Reported equity includes any losses on available for sale (AFS) securities holdings within the accumulated other comprehensive income (AOCI) account in equity. Hold to maturity (HTM) securities are tested for impairment and while temporary rate change related losses are not in equity, they're disclosed and will mature at book value.

In addition to buffers banks provide to protect deposits, FDIC insures all deposits of $250K per account per person plus $250K more per dependent named on the account. Currently, about $9.5trn of about $17.5trn of total US bank deposits are insured by the FDIC. The Federal Deposit Insurance Corporation (FDIC) charges premiums and operates to build loss reserves that now total near $125bn.

## Watching weekly bank call reports for deposits, loans, loan book composition

It's helpful to look at the data for deposits and loan growth as reported weekly to FDIC. Banks report loan loss provisions, charge-offs and net loan loss reserves in financial reports. Profitability remains healthy, but if smaller banks must pay interest on loans and deposits near 5% it hits profits hard until when they will be able to reprice loan books and let lower yield securities mature.

## What's the appropriate cost of debt and cost of equity for Banks, small and big?

This is the question that investors are wrestling with right now and ever since the financial crisis. Deposits are very safe, debt is very likely safe, equity is at risk and rarely rescued. In order for debt and equity to be willing to provide possible loss absorption, there must be an adequate probable return. Deciding what's adequate will depend on how the Federal Reserve system responds to this latest challenge, how regulators and the FDIC react and price insurance and the general support and cooperation of law makers and government.

## Glossary

The federal funds rate is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight. When a depository institution has surplus balances in its reserve account, it lends to other banks in need of larger balances. A bank with excess cash, which is often referred to as liquidity, will lend to another bank that needs to quickly raise liquidity.

The Federal Deposit Insurance Corporation (FDIC) is an independent agency created by the Congress to maintain stability and public confidence in the nation’s financial system. The FDIC insures deposits; examines and supervises financial institutions for safety, soundness, and consumer protection; makes large and complex financial institutions resolvable; and manages receiverships.

A charge-off is a debt that is deemed unlikely to be collected by the creditor, since the borrower has become increasingly delinquent.

Core inflation excludes items which can be susceptible to volatile price movements, e.g. food and energy.

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

The discount rate is the interest rate charged to commercial banks and other depository institutions for loans received from the country's central bank's discount window.

The Federal Open Market Committee (FOMC) is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

Fixed Income broadly refers to those types of investment security that pay investors fixed interest or dividend payments until its maturity date.

Loan-loss provisions are an allowance for bad loans, for example due to customer defaults or a renegotiation of the terms of a loan.

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

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