THOUGHTS FROM THE FRONTLINE

Another Unstable Finger

By John Mauldin | March 18, 2023

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> "There's an old saying: Whenever the Fed hits the brakes, someone goes through the windshield," said Michael Feroli, chief economist at J.P. Morgan. "You just never know who it's going to be." (*The New York Times*, March 16, 2023)

For years I've used a sandpile metaphor to describe complex systems like banking. Keep dropping grains of sand long enough and you will eventually trigger an avalanche.

"Eventually" is the key word. Exactly which grain will do it, you can't know.

But before the collapse, the sand grains accumulate to a larger and larger pile. They form "fingers of instability"—small weaknesses where a larger failure could begin. Sooner or later, one will break but no one knows when. Will it cause a small avalanche or "the big one?"

These unstable fingers seem to be piling up lately. Last October, the UK had a brief bond crisis when some budgetary changes revealed rather questionable pension fund activities. Then the bankruptcy of crypto exchange FTX showed how supposedly "trustless" assets can require a lot of trust.

In just the last week we've seen the second- and third-largest bank failures in US history: Silicon Valley Bank and Signature Bank. Several others look shaky. Authorities responded swiftly (and I think correctly) to stabilize these situations. I see no need to exit 99% of banks, but everyone should definitely pay attention to make sure your bank is not in the 1%. Important things are happening.

In short, this isn't 2008. But it's also not nothing.

By sheer coincidence, I'm also happy to announce registration is open for our 2023 virtual Strategic Investment Conference, the theme of which is "Thinking the Unthinkable." We'll have 40+ speakers talking about how to be truly defensive as we imagine the chain of risks that lie ahead. Neil Howe will tell us how The Fourth Turning will bring several more years of turmoil—and not just financially. You really don't want to miss this SIC, which I promise will be the best ever. [Click here to learn more and get your Virtual Pass.]

Balancing Act

Let's start with what we know. Silicon Valley Bank (hereafter SVB) had problems on both sides of the accounting ledger.

When you deposit money in a bank account, you aren't simply giving it to the bank for safekeeping. You are *lending* your cash to the bank. It is a loan transaction, with you as lender and the bank as borrower. Your deposit appears as a liability on the bank's balance sheet.

This is how modern banking works. In simple terms, the bank borrows money from you then lends it to someone else. If all goes well, the bank profits from the difference between its cost of funds (the interest it pays depositors) and interest received on the loans it makes.

Those loans support small businesses and help consumers buy cars, mortgages, etc. Banks also loan money to the government by purchasing Treasury securities. They don't yield as much but are also lower risk. But they aren't zero risk, as we'll see in a minute.

Running a bank is a balancing act because the assets (loans) and liabilities (deposits) have different maturities. People can demand their cash any time but the bank can't call in its loans, at least not quickly. It works only because most people leave their balances in place most of the time. Having a loyal, diversified depositor base helps, too.

This seems to have been a problem for SVB. Most of its deposits came from a relatively small group of venture capital firms that "recommended" the startup companies they funded keep cash at SVB. When that small number of firms decided to leave, SVB didn't have the liquidity to pay them all.

What SVB *did* have was a pile of longer-term Treasury and mortgage bonds it had bought when deposits ballooned in 2020–2021, before the Fed started raising interest rates in early 2022. When interest rates rise the market value of bonds falls. That's not a problem if you hold the bonds to maturity. It can be a *big* problem if you need to sell.

I'll skip the complexities of bank accounting except to say the higher rates put SVB in a tough spot, which got tougher as deposits shrank in recent weeks. When the miniature bank run intensified last week, it became clear SVB couldn't operate. FDIC had to jump in.

I was very critical of the Fed for their bailouts of banks in the 2008 crisis. Fairness requires that I point out they did it correctly this time. While you may or may not be a fan of SVB's customers (tech startups) they are important to the US economy. We need them. To use that word: They are systemically important. The FDIC gave SVB customers full access to their deposits, so they made payrolls and life went on. This was appropriate and, unlike 2008, they wiped out shareholders and fired senior bank management. When you %^$^ up that way, you should be fired.

I frankly would say the same thing about the Fed regulators and their ridiculous stress tests. It is honestly hard for me to believe that they could just be that blind (or pick another several dozen pejorative words).

Joseph R. Mason and Kris James Mitchener wrote a brief (and sadly overlooked) piece for the *WSJ* on Wednesday. **To me this is the heart of the regulatory failure.** Quoting:

> "Even if midsize banks had been subjected to the same scrutiny as large banks, it isn't clear that stress testing them would have led to changes that would have prevented failure. Why? Because the tests asked the wrong questions. They failed to encompass the scenarios that ultimately led to SVB's demise—large and rapid increases in interest rates.
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> "In its February 2022 Stress Test Scenarios, the Fed's "severely adverse scenario" asked banks to assess their riskiness over a three-year horizon in a hypothetical world in which the three-month Treasury rate stays near zero while the 10-year Treasury yield declines to 0.75% during the first quarter of 2022 and doesn't change in the subsequent two quarters. **Even in December 2021, however, the Federal Open Market Committee's Summary of Economic Projections was showing the Fed likely targeting interest rates double those of 2022 in 2023, far higher than what it used for bank stress tests.**
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> **"A reasonable observer would expect FOMC's policy objectives to have been embedded in the 2023 Stress Test Scenarios. But by February 2023 [!!!!], the Fed still hadn't changed its regulations to match its monetary policy.** While FOMC's December 2022 projections show its policy rate reaching 5.1% by the end of 2023, the February 2023 severely adverse scenario was almost identical to that used in February 2022: The three-month Treasury rate falls to near zero by the third quarter of 2023, while the 10-year Treasury yield falls to around 0.5% by the second quarter, then gradually rises to 1.5% later in the scenario.
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> "The 2023 severely adverse scenario's assumptions bore no relationship to reality. In February 2023, the three-month Treasury rate had already risen above 4.5%. Since Feb. 10, 2022, the 10-year has nearly doubled, from about 2% to almost 4%. Even this year, from Feb. 9 to March 10, the 10-year yield has risen by about a quarter of a percentage point."

Do the Fed's bank regulators not at least talk with or read about what their monetary policy brethren are doing? Rates have been rising for a year! The regulatory executives who somehow overlooked this should be asked to polish their resumes and seek other pastures. The excuse that historically interest rates fall during a recession so that should be the stress test scenario just doesn't hold water here.

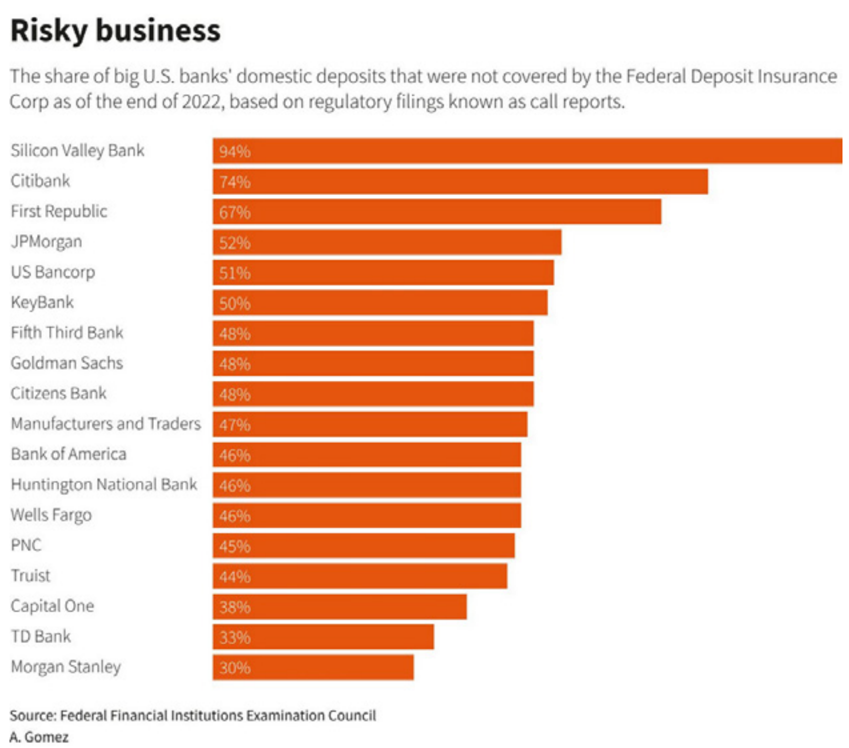
Passing more regulations and laws doesn't help if regulators are incompetent. There were more than enough laws to have prevented this. Seriously, firing senior management at the failed banks is just a start in cleaning house.

Systemically Unfair

One angle I find fascinating (and troubling) is that almost all (94%!) SVB's deposits were above the $250,000 FDIC coverage limit, and therefore uninsured. That limit is no secret. It is plastered all over bank walls and appears on almost every account document anyone signs. It should be crystal clear that larger balances are vulnerable if the bank fails. SVB depositors didn't seem to care, or believed that it didn't apply to them. As it turned out, it didn't.

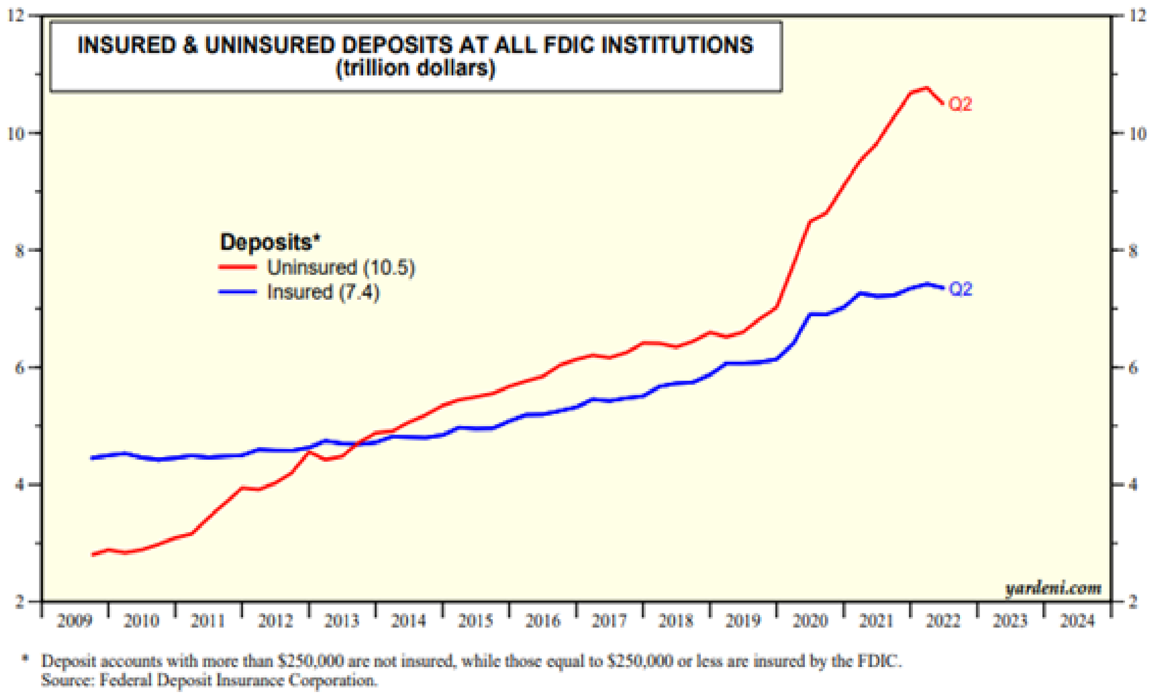
I realize even relatively small businesses need liquidity for payroll and operations. Trust me, I've been there. But my accountants and bankers have always found ways to minimize that risk. It's fairly simple to sweep excess amounts to a money market fund and bring it back as needed to clear checks. Keeping millions in the same bank just makes no sense. Yet it was common at SVB.

Nor is it just SVB. Even much larger banks can have more uninsured than insured deposits.



Source: Reuters

This hasn't always been the case. Here is a chart Ed Yardeni compiled comparing insured and uninsured deposits for all US banks.



Source: Yardeni QuickTakes

At a $250,000 limit, US banks had $10.5 trillion in uninsured deposits as of mid-2022, and only $7.4 trillion insured. A majority of deposits have been uninsured for 10 years now but notice how the line bent sharply upward in 2020. Why? It coincides with Fed stimulus and the various COVID fiscal programs… but nothing required people to keep all that money in banks.

This seems like a problem. In the SVB case, regulators used a "systemic risk" emergency clause to cover otherwise uninsured deposits. FDIC was able to do this without breaking its own finances because SVB had good assets in its Treasury portfolio. They were just illiquid.

Would the same happen at any other bank? It didn't in the past. Browse the FDIC's failed bank database and you'll see depositors in smaller failed banks often lose half or more of their uninsured balances. Even the partial recoveries they get can take years. Those banks and their depositors aren't "systemically important," you see.

The government is giving a handful of megabanks a privilege community banks clearly don't get. This may produce *more* systemic risk, not less. I don't think we want to know the answer to that question, but someday we will find out.

It's also unfair to the small local banks that are often community pillars in places the megabanks don't serve. According to the FDIC's 2020 Community Bank Survey, community banks held 30% of all CRE loans despite having only 12% of the banking industry's total assets. Not to mention all sorts of loans to locals that large banks don't make. We need them, but then handicap them.

This also introduces uncertainty. Is your balance above $250,000 protected? If it's one of the top dozen or so largest banks, certainly yes. They either won't be allowed to fail or depositors will get full coverage under that systemic importance provision.

Small community banks? If yours fails, your uninsured deposit is supposed to take a haircut, perhaps a big one. Today? Who knows?

Then there's a giant gray area of medium-sized banks that may or may not be systemically important. SVB wasn't systemically important until it was. No one knows what to expect.

This is just untenable. No one wants to see anyone hurt but at some point, people have to bear the consequence of their decisions. If a company decides to hold $50 million *or more* in uninsured bank deposits—as several SVB customers did—should they be made whole when the bank fails? Is that fair to other businesses who manage their cash prudently? What incentives does it create?

Congress, the Fed, and the administration need to take a hard look at the deposit insurance system. I don't know the answer, but the present structure no longer fits.

Fighting the Last War

The final question I want to explore today is how the Federal Reserve fits into all this. We'll get to monetary policy in a minute, but let's remember the Fed is also a bank *regulator*. It works alongside FDIC, OCC, Treasury, and assorted other agencies to ensure stability in both individual banks and the banking system as a whole. SVB's failure suggests this process needs improvement.

In the same way generals are accused of planning for the last war, financial regulators plan for the last crisis. After 2008, Congress passed the Dodd-Frank Act with many new rules and requirements intended to prevent another such event. And in that narrow respect, it worked: We haven't had another subprime mortgage crisis.

But as regulatory legislation usually does, Dodd-Frank also had gaps and unintended side effects. Not to mention puzzling application of the rules by the regulators themselves.

Dodd-Frank and its appendages focus mainly on reducing bank credit risk, i.e., the kind of mortgage activity that brought down several large institutions and countless small ones. The new requirements encouraged (or in some cases mandated) banks hold more Treasury securities, which in theory have no credit risk. They didn't consider the *interest rate* risk banks would take by holding those bonds.

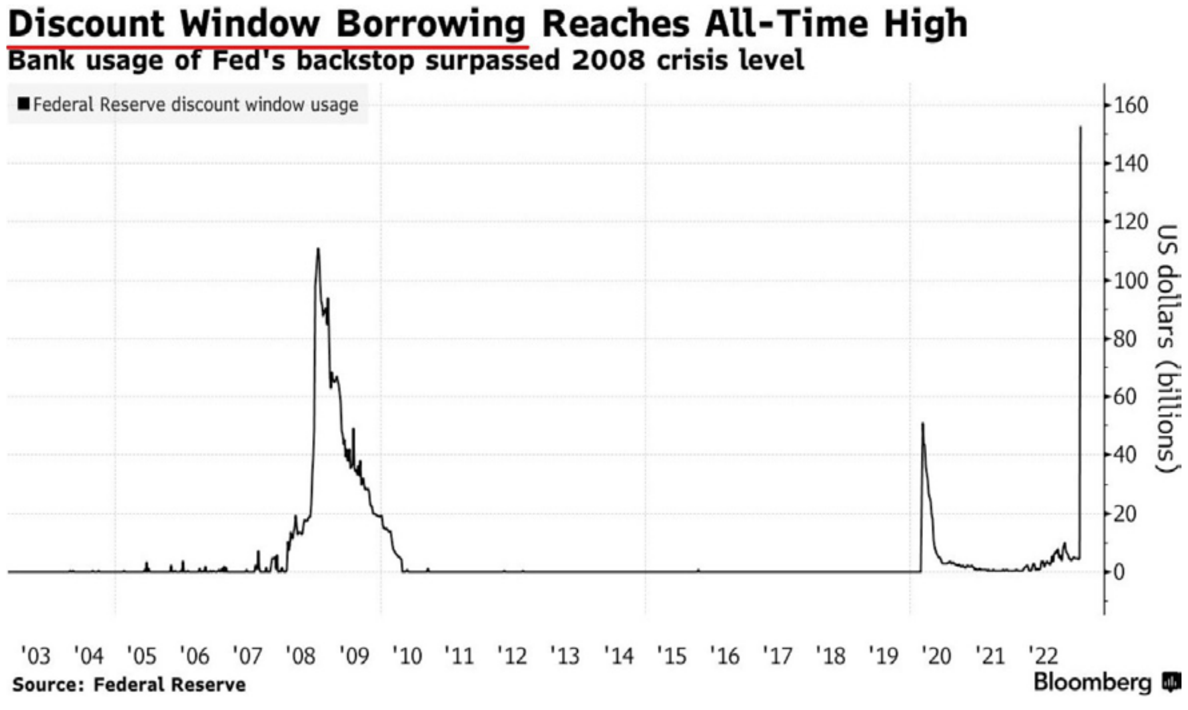
In fact, they did just the opposite. They let banks put long-term Treasuries/mortgages in a special regulatory bucket that didn't require marking those assets to market against their capital base. They were only marked to market when actually sold. If bank management and regulators couldn't see this as a problem, it has to give one pause about who is watching the watchers.

Even so, everything was fine until inflation put the Fed in a bind. The obvious answer was to tighten credit by raising rates and reducing the balance sheet. But the same Fed was also overseeing a banking industry not necessarily prepared for that scenario.

So now the Fed is in another bind. Earlier this month Jerome Powell was sounding quite hawkish. Many traders were expecting another 50-point hike next week. Now everyone has to wonder whether it will push more banks over the edge. At the same time, *not* raising rates next week risks letting inflation start climbing again.

Barring some other major event, I think the Fed will continue tightening next week. I will take the over on the bet as to whether they keep raising rates for the next two meetings. They are hyper-focused on inflation, as they should be. That doesn't mean they aren't worried about banks. I'm sure the FOMC statement will include some new line about "monitoring developments closely."

And despite the huge increase in their balance sheet this week, the Fed will still continue quantitative tightening. The increase came not from a stealth QE, but from pledging their long-term assets for new liquidity. While obviously a sign of stress—it's also exactly how the system is designed to work in times like these. (h/t Rene Aninao and CORBU for this chart.)



Source: Bloomberg

Nor is it just the discount window. The Fed's new Bank Term Funding Program allows banks with unrealized losses in their Treasury securities to pledge them as collateral and get cash from the Fed. Presto, instant liquidity for those who overloaded on T-bonds and/or forgot to hedge the risks. Depending on how far down the banking food chain this goes, it may solve the immediate problem. (Normal bank insolvency will still result in bank failures. Depositors at small banks will find out.)

This is, of course, unfair to the prudent banks. The Fed is essentially rewarding unwise risk-taking. The fact is that this is done within the regulatory guidelines doesn't mean there is no risk, just bad guidelines.

Policy thought: We really do need to have a conversation about FDIC limits, bank regulation and policy, not just in the Fed but in Congress and the public. Is $1,000,000 the right number for deposit insurance? I don't know. I know that a million today isn't what it used to be. Should depositors who hold money over that limit be forced to share the FDIC cost so we can ensure all deposits? I don't know, but we should be asking these and more questions.

But I also think about that sandpile. It's not just banking. Commercial real estate, the markets, global trade, a clearly slowing manufacturing base. The massive rise in sovereign debt worldwide. And so much more. It's getting bigger and eventually…?

Travel, SIC, and Loans

I still want to get to Austin and New York but don't have the actual dates set. I need to get to Colorado Springs to see my new grandson, Odin. Mama and baby are doing fine.

I've been working hot and heavy on getting the final faculty lineup for the SIC. This will be the best year ever. You really should register now to take advantage of the discount.

Speaking of banks and loans, back in the late 1970s I had a $10,000 loan from the First National Bank of Euless, Texas. I used it to buy a literal 40-ton train carload of paper. Paper supply was very tight and prices were rising faster than inflation. It gave me a big business advantage at the time. FNB Euless got in trouble and wanted to call the loan. I pointed out the terms we had agreed to (I didn't have the cash) and told them we would try and work it out.

That wasn't enough for them. I found out a few months later they had called my MOTHER and told her that my credit and other prospects would be ruined if she didn't give them the money to pay off my loan. She paid them, from where I don't know. She never told me. The bank still went under. And you thought your banker was ruthless.

It's time to hit the send button. You have a great week! And don't forget to follow me on Twitter!

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