PROANALYSIS

WHAT YOU NEED TO KNOW ABOUT

Regional Banks

BY VICTORIA GUIDA AND ROSMERY IZAGUIRRE AND PAROMA SONI | 08/22/2023 05:00:00 AM EDT

PRO POINTS

- **Regional banks have seen their profit margins squeezed in the wake of Silicon Valley Bank's** collapse, causing volatility in their stock prices and increases in their borrowing costs.
- **These lenders are already facing an uncertain economy and are more exposed than their larger** counterparts to weakness in the commercial real estate sector. Banks with between $100 billion and $250 billion in assets are also bracing for tougher regulations, which are aimed at fortifying the institutions but will increase expenses.
- **These troubles are contributing to a pullback in lending by midsize financial institutions, which** could bite into economic growth.

HOW WE GOT HERE

The Federal Reserve has raised interest rates at a rapid pace to fight inflation — more than 5 percentage points since March 2022. While that has allowed banks to reap higher revenue on loans, it's also meant more competition for deposits, since customers can usually earn more by putting their cash somewhere other than in their bank account.

Higher rates have also eroded the value of assets on bank balance sheets; yields on newly issued U.S. government debt and other bonds are higher, making older, lower-rate assets drop in price. That dynamic came to a nasty head for Silicon Valley Bank, a regional lender whose tech-focused customers were particularly vulnerable when easy money began to dry up. As the bank's deposits dropped over several months, SVB eventually sold some of its assets at a loss to replenish its cash. The resulting loss of capital caused depositors to panic and pull their money in an exceptionally fast bank run, causing SVB to collapse.

Signature Bank, another regional bank that faced some similar problems, followed the same weekend, and First Republic was fatally wounded, eventually failing a little over a month later.

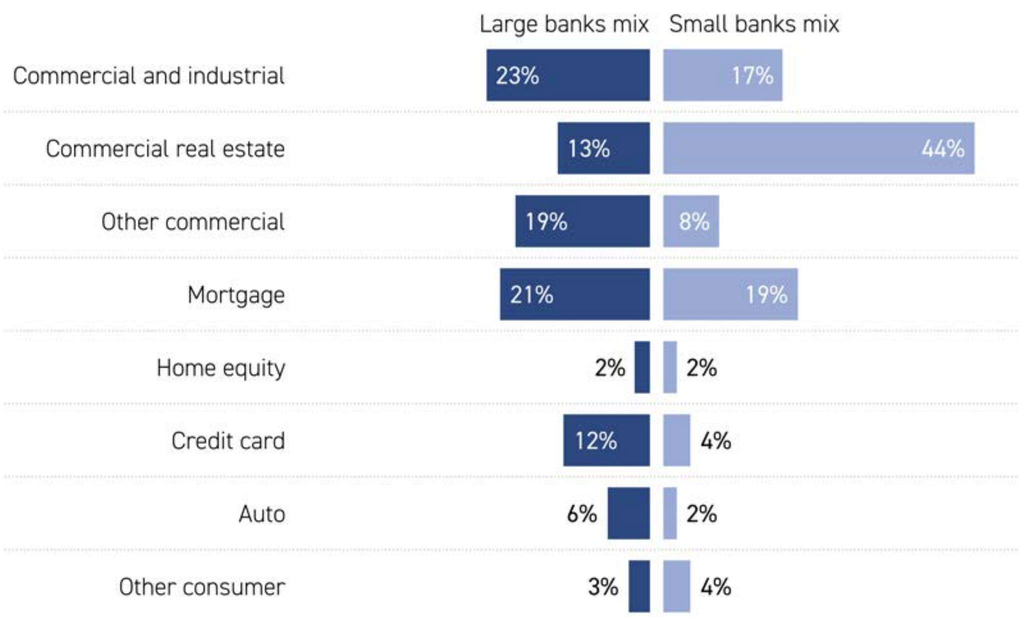
Even though depositors have stopped fleeing, investors continue to scrutinize banks that have significant unrealized losses on their assets. To help banks temporarily sidestep that problem, the Fed set up a new expanded program where it would accept lower-value bonds as collateral for loans of up to a year, a limited period that might diminish how much comfort it provides to markets.

Lower stock prices could also be interpreted as broader skepticism about the business models of these types of firms — that is, more of a concern about profits than about solvency. Smaller lenders have the benefit of so-called relationship banking, where they have valuable ties to their customers, while megabanks benefit from economies of scale. Regional banks fall somewhere in the middle.

Meanwhile, it's possible that commercial real estate is weighing heavily in investor considerations in the short term, though it might not signal as much long-term trouble for midsize lenders once they have weathered that problem.

Small banks have more of their loans weighted toward the commercial real estate sector

Loan mix of large and small banks, by category, as of July 2023



Large banks are defined as the 25 biggest banks; small banks are all other banks.
Source: Jefferies, Federal Reserve

WHAT'S NEXT

Regulators have begun to roll out a raft of new rules for regional banks designed to prevent a repeat of SVB. A new sweeping proposal would subject banks with between $100 billion and $250 billion in assets to capital rules that already apply to their larger regional counterparts, including a backup requirement known as the supplementary leverage ratio. And all lenders above $100 billion would also be required to have funding to cover unrealized losses in their securities holdings that are classified as available for sale.

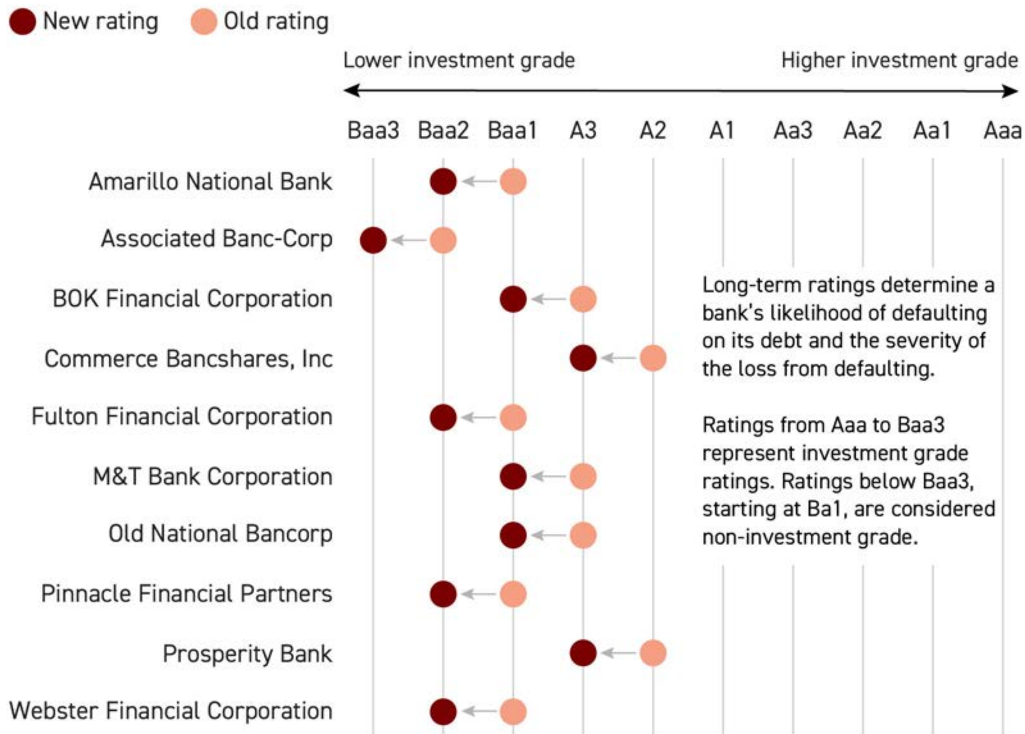
Under the entire draft rule, which is intended to implement international standards finalized in 2017, firms with more than $250 billion in assets that aren't deemed important to the global financial system would see 10 percent higher capital requirements, while the $100 billion to $250 billion group would see a 5 percent increase.

More is in store. Megabanks are already required to hold long-term debt that can be "bailed in" as equity to help cover losses in the event of failure. The banking agencies are now set to propose extending that requirement to not only "super-regionals" like Capital One and PNC, but all regional banks with more than $100 billion in assets. And a revamp of banks' cash management requirements is also on the agenda.

In the meantime, regional banks' funding costs have risen, with many forced to raise their deposit rates. Moody's earlier this month downgraded its assessment of the creditworthiness of 10 regional banks, and said multiple major banks were on review for a downgrade, including Truist and U.S. Bank.

Moody's downgrades ratings for 10 banks

Decrease in bank credit ratings by Moody's on Aug. 7



Note: Ratings are for long-term issuance except for M&T Bank Corporation, Amarillo National Bank, and Associated Banc-Corp, which are for long-term senior unsecured, long-term deposits and local currency subordinate, respectively.
Source: Moody's

Looming defaults in commercial real estate, for example, could pose major challenges for this segment of the industry, a condition that would worsen in the event of a recession, which Moody's expects to arrive early next year.

The Fed has suggested that more rate hikes could be in store, and at the very least, borrowing costs are expected to remain high heading into next year. That's led even some megabanks like JPMorgan Chase to warn shareholders that their deposit bases could deteriorate.

POWER PLAYERS

- **Martin Gruenberg:** The chair of the Federal Deposit Insurance Corp., who has been at the agency since 2005, has been a leading proponent for bolstering the loss-absorbing capital buffers of regional banks, even before SVB's collapse.

- **Rodgin Cohen:** The senior chair of law firm Sullivan & Cromwell is deeply involved in prospective mergers between banks. He served as an adviser to PacWest Bancorp and Banc of California, which announced last month their plans to join forces.

- **Frank Holding:** The chairman and CEO of First Citizens Bank has steadily grown the regional lender by buying a raft of failed banks since the 2008 financial crisis, most recently acquiring the assets of SVB. His firm is now among the 20 biggest banks in the country.