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Who's next?

Equity markets were broadly down last week due to the selloff in banking stocks. This was caused by the failure of First Republic Bank (FRC) which led to the takeover of JPMorgan (JPM). Jamie Dimon, JPM's Chairman and CEO, said that this stage of the crisis is over. However, market volatility continued as equity and bond investors of FRC suffered massive losses.

Contagion risks resurface

FRC has been the subject of speculation that it would be the next casualty of the ongoing banking crisis. This finally came into fruition as FRC failed after experiencing continued deposit outflows despite getting a lifeline of $30b in deposits from a consortium of major American banks. FRC was auctioned by the Federal Deposit Insurance Corp (FDIC) with JPM emerging as the winner. FRC fell 77% last week and is down 98% since March.

Domino effect

FRC's failure comes after the collapse of Silvergate Capital, Silicon Valley Bank, and Signature Bank (see Bank Rout, March 13, 2023). These banks had a high level of uninsured deposits that typically flee during signs of trouble. Liquidity problems forced them to sell their bonds even as they incurred substantial losses due to the impact of higher bond yields. Investors are now wary of a potential financial contagion. A domino effect may be unfolding as everyone wonders who would fail next. The failure of FRC triggered a selloff in regional banks led by PacWest Bancorp (PACW) which fell 51% last Thursday.

Fears of a credit crunch

Last week, Biden reiterated the government's stance on bank rescues. He said, "Let me be very clear: our depositors are being protected, shareholders are losing their investments, and critically, taxpayers are not the ones that are on the hook." This followed the same template as the government-mandated takeover of Credit Suisse by UBS.

Regulators have recently shown an aversion to providing direct bailouts to owners of failing banks. Instead, they are asking private institutions and stronger banks to initiate rescues and takeovers. With heightened risks, tighter rules, and lower regulatory support, the business model of banks is now being scrutinized and questioned. Given this backdrop, banks may lose appetite for credit or even restrict their lending activities as they protect their own balance sheets. This can result in a full-blown credit crunch that can lead to a painful economic recession.

Caught by surprise

In his press conference last week, Powell highlighted the challenges that regulators are confronting in light of the unprecedented pace of recent bank failures. We summarized some of Powell's comments below.

- "The run on Silicon Valley Bank was out of keeping with the speed of runs through history. And that now needs to be reflected in some way in regulation and in supervision."
- "I'm not aware of anybody thinking that this could happen quite so quickly."
- "I think it's probably good policy that we don't want the largest banks doing big acquisitions. That is the policy, but this is an exception for a failing bank and I think it's actually a good outcome for the banking system."
- "It's pretty clear, to me anyway, that we need to strengthen both supervision and regulations for banks of this size."

Loss-sharing scheme

The FDIC announced that it was considering loss-sharing agreements with non-bank entities and private equity firms that would acquire assets of failing banks. This type of agreement has only been provided to acquiring banks, and offering it to non-banks would boost interest for troubled banks that are up for sale. The proposed loss-sharing scheme, robust jobs report, strong Apple earnings, and short squeeze fueled last Friday's market rally.

The last hike

Despite reemerging concerns on the banking sector and initial signs of easing inflation, the Federal Reserve (Fed) hiked its policy rate by 25 basis points last week. Below are some quotes from Powell which state the Fed's policy stance.

- "Inflation has moderated somewhat since the middle of last year. Nonetheless, inflation pressures continue to run high and the process of getting inflation back down to 2% has a long way to go."
- "We on the committee have a view that inflation is going to come down not so quickly. It will take some time. And in that world, if that forecast is broadly right, it would not be appropriate to cut rates, and we won't cut rates."
- "A decision on a pause was not made today."
- "We are prepared to do more if greater monetary policy restraint is warranted."
- "Looking ahead, we will take a data-dependent approach in determining the extent to which additional policy firming may be appropriate."

A crucial change in Powell's official statement was the removal of this sentence: "The Committee anticipates that some additional policy firming may be appropriate." Though he did not commit to a pause in tightening, Powell's remarks open the possibility that the latest rate hike may indeed be the last hike.

Fed policy mistake?

While depositors are being protected by regulators, equity and debt investors continue to suffer painful losses as the contagion unfolds. Some market pundits are wary that overtightening may result in more bank failures and a full-blown credit crunch that would trigger a deep economic recession. US regulators have taken the initial steps to address the ongoing banking crisis. On the other hand, the Fed continues to maintain a restrictive policy, thereby fanning concerns of a potential policy mistake. It is therefore critical for banking regulators to take action in order to restore trust and confidence in the US banking system.

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