The Week of Bank Collapses: A Q&A

Presented by Warren Wealth Associates

It's easy to summarize in one word what dominated headlines last week: banks. The collapse of three banks, with several more under pressure, caused confusion and panic, leaving many Americans wondering whether their money was safe, among other concerns. Let's delve into the questions that arose from this situation and explore what it all means—and why it matters.

Q: What happened?
A: After three major bank shutdowns, including one major sector bank (Silicon Valley Bank), the government stepped in aggressively to stop a wider problem, taking over that bank and guaranteeing all deposits. Second, the government also stepped in to help other banks with similar solvency risks, offering a new program that lends against bank assets at par, giving them time to resolve those problems and prevent closure.

The FDIC also enhanced its review and surveillance process to get ahead of the problem with the rest of the industry. Finally, several large banks combined to aid First Republic Bank, which was also under threat, putting in tens of billions of dollars in deposits as a vote of confidence. Looking abroad, we saw a similar problem with Credit Suisse and a similar solution, as the Swiss National Bank put in tens of billions of dollars to support it.

Q: What caused these collapses?
A: From a distance, there are two things going on. First, some banks got in trouble as they borrowed short term with their deposits and lent long term in government bonds. When depositors found out about it, they pulled their money in a classic bank run (watch *It's a Wonderful Life* if you haven't already). This is obviously concerning—but it is also reassuring, and we will get to the reasons for that shortly. Second, and unlike the 2008 financial crisis, governments here and abroad decided to step in before a systemic blowup, rather than trying to clean up afterward. That is also reassuring.

Q: What will the consequences be?
A: With the government taking a much harder look at the books of banks and likely to show much less patience with problems, we can expect to see more banks publicly flogged or even shut down. Expect a phase akin to a bandage being ripped off over the next month or two. Because this past week has seen a classic bank run, with clear-cut reasons that can be identified and dealt with, the problems going forward should be easier to identify and solve proactively.

That solution won't come only from the government. As we've seen with drops in stock prices of regional banks and the relocation of their deposits to larger banks, businesses are now actively reviewing their risk exposure to their banks. Why take a risk at a bank that may be small enough to fail when you can be at a bank that is too large to fail? The regional banking sector is in for a very tough few quarters as banks fight to retain their customers, but the government has laid the foundation for them to strengthen their balance sheets and survive. With that cushion, the private sector can now start to solve the problem.

The difference between regional banks (large enough to have significant uninsured deposits) and smaller, local banks (with a primarily retail depositor base, the vast majority of whom have less than $250,000 in deposits and are therefore fully insured) is worth noting. Smaller banks will face much less pressure, as we are seeing in the markets.

Q: How will banks react?
A: Banks will pull back. Less pressure does not mean no pressure, and all banks face the same problem: the erosion of the value of their assets with higher interest rates. The decision by the government to allow them to borrow against those assets at par instead of market value will allow them, for a time, to fill that hole. But that means they must cut costs, reduce their liabilities, and generally pull back on everything. That will lead to slower growth and tighter financial conditions. If there is one thing that will bring the much-discussed recession forward, this is it.

Q: Is this positive at all?
A: From a Federal Reserve (Fed) perspective, this is a good thing; in fact, this is what the Fed has been trying to accomplish. Lower interest rates in the market are a direct result of a more likely and deeper recession this year, which would make the Fed stop raising rates sooner—and maybe even push them to cut rates. Those lower interest rates have also started to solve banks' asset valuation problems. So, despite the headlines and turmoil, this week could end up marking a turning point for the better.

But first, we'll have continued turmoil while the banking system sorts itself out and recapitalizes, while we see whether there will be a recession and how bad it might be. Markets are struggling between worst-case scenarios and not-as-bad (but still pretty bad) scenarios. With so much uncertainty, it will take some time to sort out.

Q: Will we bounce back from this?
A: Here's the good news: between the government's strong action and the resultant drop in interest rates, we are moving toward a solution faster than anyone expected. That cuts off much of the downside risk—a rerun of the great financial crisis looks less and less likely—and should accelerate the rebound eventually.

We can expect more volatility, but it's not the end of the world.

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