

## **Banks Are in Trouble: How This Impacts You**

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### **How they Got Here**

**For the past decade, Commercial Banks have faced an extraordinary challenge: How to make money in a near zero-interest rate environment?**

**Over time, as their maturing high-rate loans and Securities that provided satisfactory interest rate margins over their cost of funds rolled off, those assets that were generated and purchased during the prior “normal” interest rate environment that existed before the “near zero rate environment” arrived, banks suddenly faced an enormous new challenge of how to deploy the cash from maturing securities and loan repayments inside a much lower interest rate environment, with far lower returns to the bank than was historically the norm. To make matters even more challenging, as the banks grew in size, the challenge continued, what could they do with the growth in deposits coming their way from customers?**

**In the environment where a Treasury Securities Portfolio yielded just 0.25% to 1.00% for short and medium term maturities, with a bit more yield possible for higher risk agency securities, municipal securities, or even the greater credit risk of corporate securities, with banks flush with .01% to 0.25% deposits, they were faced with an incredible earnings challenge, how to come up with sufficient interest spread from earning assets over their cost of funds, to cover administrative costs, reserves for loan losses, while providing a satisfactory return on investment for shareholders, including continued uninterrupted dividends.**

**So, they came up with a few ways to deal with this:**

- 1) Strategy # 1: Find a large source of fee income generation, which is what the mega Wall street banks used as a key strategy, but was not a sufficient viable option for most regional or community banks.**

**2) Strategy # 2: Take a chance that long term interest rates would not rise any time soon, or in the distant future, so extend the maturities of the securities portfolio (which might make up 25% of so of an entire bank's assets) to capture 2% to 3% yields that a longer-term portfolio of securities might provide, instead of the 0.0% to 1.0% revenue that a moderate or shorter-term securities portfolio would provide. The thinking was, if they funded longer term securities with essentially 0% interest deposits, they could be happy with the 2.5% to 3.0% interest rate spread, a satisfactory net interest margin, and so they would choose to be willing to accept the future possible interest rate risk that could come from a possible decline in the value of the securities portfolio, perhaps even a substantial drop in value, during a sudden rise in interest rates.**

**Further, to chase yield, not only would they set up a long-term fixed rate securities portfolio, but also build in higher credit risk securities that would further bump up the returns, but again, even to do this, longer terms of these fixed rate instruments would be required to get those higher yields, say 3% instead of 2%, by purchasing a combination of Federal agency paper, Municipal securities, and higher credit risk Corporate securities.**

**The problem with this strategy is, should the bank's cost of funds, primarily shorter-term deposits than the term on the securities, rise sharply, the yields on the securities would be insufficient to maintain a satisfactory interest rate spread, and perhaps that margin could even go negative if the rate shock was sufficient. If they had an overall yield on their securities, which make up around 25% of the banks' assets, of 3%, but deposit interest rates suddenly rose to 3.5%, then one-quarter of the entire bank's assets would be losing money.**

**But another risk sits here with this strategy: And this one cost the banks that went down the tubes back in March 2023. Should there be a run on their deposits, excessive sudden withdrawals of deposit funds, for whatever reason, perhaps a rumor about the banks' bad loans rising, or deposit rates are rising and the bank is not willing to pay competitive**

higher deposit interest rates, or whatever, the bank will not be able to liquidate or use their securities portfolio as adequate collateral for deposit replacement borrowings from a Federal Government agency or a mega-bank. That would be because of securities market value risk.

With this strategy, there would be huge market valuation mark-to-market risk for the securities portfolio should interest rates for comparable securities suddenly rise substantially (as we just saw over the past year and a half). The bank could not sell the securities it held as the loss from market value deterioration would be greater than the capital of the bank. In other words, on a mark-to-market basis, the entire balance sheet of the bank would be insolvent. We just saw this with the bank failures of March 2023.

This sets up another risk, liquidity risk, as word would get out once their financial statements are published and available to the public, that the value of the securities has dropped substantially below current market value, triggering a panic run on deposit withdrawals, which is what we saw with the large banks that failed in March 2023. The bank cannot sell the securities that are underwater as that would wipe out the capital of the bank. They cannot borrow with the securities as collateral because the borrowings required would be so high, so outlier, that the Regulators would have to seize the bank.

- 3) **Strategy # 3: Avoid the potential interest rate risk of a longer-term securities portfolio, and instead, apply the vast majority of deposits to fund loans to be placed in the portfolio. Commercial loans, Home Equity loans, Adjustable rate Mortgage loans, Credit Card lines, and other Consumer loans. The risk with this strategy was a bank would land with a loan to deposit ratio that would be outlier, greater than the tried and true normal 70% ratio, putting the bank at great liquidity risk should deposits leave.**

This strategy also left itself at interest rate risk if deposit interest rates spiked quickly, yet the yield on the loans that were set at fixed interest

rates with longer term maturities could not be increased, shrinking their net interest margin between loan yields and the interest cost of deposits and borrowings. Generally, loans are less saleable than securities in the trading market between banks and investment houses, although many are saleable if underwritten well, however if the fixed rates on these loans are below the current market interest rates for similar loans after a rising interest rate shock like we just had, the same problem exists as with a fixed rate securities portfolio. To sell the loans, would require taking losses that would likely wipe out the capital of the banks selling them at market value.

Another risk with # 3 was that borrowers may not be able to make their loan payments on time, or at all, if their variable interest rate loans the banks put on the books suddenly rose in a fast-rising interest rate environment. Loan delinquencies and non-paying loans could rise as consumers and businesses found themselves in a position that they cannot afford to pay the higher interest rates the bank was suddenly charging them on their variable interest rate loans. This in turn would require the bank to start charging off loans, taking losses, and building reserves for possible future loan losses which requires a large expense allocation. Once again, should this happen en-masse, to a large degree, the capital of the bank could be at risk, since capital is only 5 percent or so of all assets, and loans are 90 percent of all assets in this environment. In other words, if the bank has to write off 5 percent of its loans, it could wipe out most of its capital.

How is this a risk? Many borrowers saw very low interest rates for loans for many years, so they just borrowed and spent, thinking those interest rates would remain in place. The shock from the Prime Rate rising, and Libor rising, which was the base-line for setting many consumer and business loans and lines of credit, would suddenly put loan repayments from borrowers in peril.

The problem is, Loans were made by the bank during the low interest rate environment, and aggressively as a solution to find an alternate to low

*yielding securities, based upon the borrowers' ability to pay the lower monthly payments that low interest rates made possible. But those same borrowers would not be able or willing to make loan payments on time if interest rates charged to them would increase substantially and suddenly.*

They just did not have the wherewithal, and banks did not see the need to "shock test" if borrowers could. It was not part of the loan credit granting process. Banks that used the strategy felt at the point of generating the loan that they had adequately managed their interest rate risk should interest rates rise if they booked adjustable interest rate loans. They believed that, should their interest cost on deposits rise, so would their loan revenue automatically, so their net interest margin, profit margin, would remain stable, or possibly even increase. However, what they failed to do was consider the rate shock to the borrowers' ability to afford a higher monthly payment as the floating loan rate rises. This is resulting in an increase in loan delinquencies and loan losses to the bank as customers' ability to pay weakens as their loan interest rates increased.

### **The Situation Now**

Well, the worst-case scenario has occurred. Those who went the long-term securities route when interest rates were low, now have a deep underwater portfolio that is illiquid. The fixed rate loans made during the low interest rate environment are also unsaleable at near current market values because their interest rates are now below market rates, so are underwater. The Banks' deposit cost of funds is on the rise, shrinking their interest rate margins, and as competitors raise rates to avoid a liquidity crisis, it pushes deposit rates so high that margins shrink.

Banks who went the loan mostly route with asset management find themselves tapped out, up against maximum loan to deposit ratios. Plus, their loans are now starting to see delinquencies and defaults, so are now in jeopardy of loss and having to be written off. The banks that went the heavy loan route are now shutting down their lending function, especially their commercial lending function. One local bank commercial lender actually recently told a high-profile

**community customer looking for a \$2.0 million construction loan that they are no longer making commercial loans.**

**If banks retard lending, money supply shrinks and the economy shrinks, especially retarding aggregate supply of goods and services. This has the potential for incredible economic contraction, bank safety and soundness issues, and a potential black hole that feeds on itself.**

### **The Bank Regulator Factor**

**The mainstream media would have us believe, that the Bank Regulators are all over these risks, and are protecting depositors and by extension, investors in bank stocks, with keen oversight, and marvelous analytics. But for the media, all that seems to matter is how the big guys are doing, J.P. Morgan-Chase, Citicorp, Goldman-Sachs, Bank of America. Those are the banks getting the headlines. However, there are thousands of other banks around the country that matter. 70 percent of all business comes from small businesses, and 70 percent of all consumption comes from individuals.**

**The truth of the matter is this, and this is a repeat of history that contributed to every severe economic recession the past century: The worst thing the Regulators can experience is embarrassment, that they missed a problem bank, and it ultimately required seizure or arranged sale and takeover by a bigger bank.**

**So, human nature being what it is, right now, I assure you, the Bank Regulators across this country, whether Federal or State, are putting pressure on Banks to curtail lending. They are classifying marginal loans as substandard, and good loans (for now) as marginal, in anticipation of the delinquency and non-payment issues coming down the pike, as I noted above.**

**This does two things: First, from a Micro perspective, it takes away the appetite of a bank to make loans since they are considered high risk assets and under intense scrutiny by Regulatory examiners. Second, it forces banks to reduce earnings by charging more expense to their Reserve for Possible Loan Losses. This will go on for a long time, until politics demands that banks again boost lending. This was one of the reasons that Bill Clinton beat George Bush the First**

**in 1992. Clinton promised to open up lending again to consumers and businesses.**

**Second, from a Marco perspective, How does Money supply grow? How does M-2 and M-3 grow? Answer is, the Bank Lending function. It is the money multiplier effect from a loan. So, as Bank Examiners march around slowing down lending, with intimidating evaluations of the bankers, and in many cases, rightfully so, so too, we can expect the nation's aggregate money supply to continue to shrink, which is a recession inducing, contractionary economic factor.**

#### **How to Know if Your Bank is in Trouble, or on the Brink**

**#1) One clue if your bank is in trouble: They have stopped making loans, or curtailed lending dramatically. Call and ask for a loan and see how they treat you. Are they rude? Do they not call you back? Then guess what, they likely have been given orders from on high to stop lending. Watch out for your credit card or small business lines of credit. If they start lowering them on you, that bank is likely in trouble. And, pay attention to the interest rates on them. Have they risen substantially, maybe doubled from 5% or 6% to 11% or 12%? Are the credit card rates now in the mid-20% area, from mid-teens area?**

**# 2) If your bank is suddenly offering interest rates on deposits significantly greater than competitors, there could be a liquidity problem brewing for them.**

**# 3) Ask for a copy of the bank's latest year-end financial statement, or look online under their Investor Relations button on their website. If it is not made available to you, that could be a yellow flag warning.**

**# 4) If you get a copy of the Bank's latest year-end financial statement, look for a few important items such as:**

**A) the ratio of their loans to their deposits. If it is greater than 70 percent, that is a yellow flag, and if it approaches 90 percent, it is a red flag.**

**B) Make sure the capital of the bank is greater than 5%, preferably closer to 8%.**

**C) Study the types of deposits they have. The more deposits from customers greater than the \$250,000 FDIC limit, which they should break out for you in a separate category, known colloquially as “hot money,” the more risk for that bank. If that category is greater than 20% of all deposits, I would say that is too much risk in this environment. 10% would be a more comfortable level, as that amount can more easily be replaced by a prudent bank, with borrowed funds from a mega bank or federal agency, in an emergency.**

**D) Look at the Loan Loss analysis provided, delinquencies, etc... to see if they are larger than 1% of loans. Look at the size of their Loan Loss Reserve as compared to the size of their Loan portfolio. In this economic environment, if their reserves are under 1%, for me, that is a red flag. Banks should be building a substantial Loan Loss Reserve in this environment for all the above reasons cited.**

**E) Look at the section on the profile of the Securities portfolio, to examine what the overall yield is on it. Is the overall yield below current market interest rates? Is a significant percent of the portfolio long term, with maturities greater than 5 years? If so, red flag. You want to see them with an equally distributed laddered maturity portfolio structure, where at least 30% are maturing in year one,**



maybe another 30% in year two, and maybe another 30% in year three. Perhaps the remaining 10 percent up to five years out is acceptable, but not more, and not if they are at substantially lower yields than we currently see.

F) Study what their off balance sheet risk is, with various derivative instruments such as interest rate swaps, credit swaps, etc.. You would prefer to not see a lot of that in this environment, unless the bank is extremely sophisticated in its expertise in these areas, such as the large mega-Wall Street behemoths, but even there, risk is abundant, and expertise questionable. These items can be a bit of “house of cards” activities.

G) Read the “Management’s Discussion and Analysis” section carefully. Have the Bank Regulatory bodies issued this bank a Memorandum of Understanding, or a Cease-and-Desist Order? If so, that is a major red flag.

#### Where to Put Cash?

Look for the better run banks, in better condition than most, per the above risk analysis we have mentioned.

A very conservative strategy would be have some cash under the mattress (figuratively speaking, meaning kept nearby in a safe), in case ATM issues happen. Another strategy is to not have any deposit accounts unless the bank has FDIC insurance, and further, have no cash balances in a bank above current FDIC insured coverage limits (nothing over \$250,000). Another idea is to diversify your cash among

**several FDIC insured banks in case of seizures, which could cause delays of withdrawals.**

**Make sure you have your current bank deposit statements at your disposal to prove your balances, maybe even in paper form. Stick them in a drawer or safe somewhere in case a seizure happens and you need to show proof of your deposit.**