Regional Banks Stabilize, Yet Pressures Remain

Regulatory changes will do little to solve higher cost of funding.

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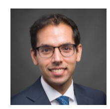

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KEY INSIGHTS

- Regional banks still face higher funding costs as well as pressures as the Fed's quantitative tightening process drains reserves from the banking system.
- Costs associated with replenishing funds for deposit insurance will have a one-time impact on bank earnings but should minimally affect liquidity and capital.
- Impending regulatory changes, such as higher capital requirements, are unlikely to address the liquidity and funding pressures on regional banks.

Credit rating agencies Moody's and Standard & Poor's downgraded several regional banks in August, reinforcing some investor fears about lingering pressures affecting the sector. We think, however, that the fundamental health of most of these firms has not deteriorated since the high-profile failures of Silicon Valley Bank and other mid-size banks in March. But that's not to say that the picture has meaningfully brightened for regional banks—they still face higher funding costs as well as pressures stemming from the Federal Reserve's quantitative tightening (QT) process that drains reserves from the banking system.

Assessment for Covering Uninsured Deposits

Regulators have implemented (or are in the process of implementing) changes since the regional bank failures earlier in the year. Because the Federal Deposit Insurance Corp. (FDIC) ultimately guaranteed all deposits at the failed banks—even funds in excess of the standard USD 250,000 limit—the government is now assessing a fee on banks to recoup some of that cost. Backstopping even uninsured deposits likely prevented a wider run on regional banks.

This assessment could result in a one-time decrease of about 25% in third-quarter earnings for most regional banks as they account for the newly implemented FDIC fees. This is significant, of course, but manageable from a bondholder perspective, and it appears be priced in to regional bank equities. The FDIC assessment will have a larger impact on banks with a higher share of uninsured deposits, such as trust banks, but its effect on liquidity for most regional banks should be more limited as the cash payments will take place over several quarters.

We believe that elevated funding costs are at the core of the challenges for regional banks....

Higher Capital Requirements are Coming...

Bank regulators also plan to impose higher capital requirements on regional banks, though the details have not yet been finalized. However, unlike in 2008, the banking system isn't in desperate need of capital, and it is difficult to see how higher levels of capital will solve the liquidity and profitability issues that regional banks face.

In our view, regulators tend to raise capital requirements as a salve for any bank ailment. But in the current environment, the action may only give nonbank lenders—which would not be subject to the higher capital levels—a competitive advantage.

...But Won't Address Key Risks

Higher capital requirements won't eliminate the risks posed by regional banks' exposure to commercial real estate, which haven't materially changed since the bank failures in March. While troubled commercial real estate loans garner many headlines, some segments of commercial properties—like data centers—remain fundamentally sound.

Of course, office property values are being dragged lower as remote working has taken hold and firms downsize their office footprint. However, loans on office properties represent only 2%–3% of the total loan portfolio at most regional banks, so it's hard to see how a potential wave of defaults on office properties could create a systemic problem for regional banks. In addition, banks have anticipated these issues with office properties for some time and have prepared by setting aside reserves to offset losses.

Elevated Funding Costs at the Core of Challenges

We believe that elevated funding costs are at the core of the challenges for regional banks, just as was the case in March. With deposits still susceptible to flight to the much higher yields available in money market funds, banks are in the unenviable position of needing to boost the interest rates paid on deposits or to borrow in wholesale funding markets (such as from the Federal Home Loan Banks). Either way, the cost of funds is meaningfully higher than in the post-global financial crisis era of ultralow interest rates. With the marginal cost of funds[1] for many regional banks now running at 4%–5%, it's much more difficult to make profitable loans with reasonable credit risk.

The Fed's QT program continues to drain reserves from the banking system, gradually removing an inexpensive source of funding for banks. This pushes them into the wholesale funding markets, which are much more expensive than the near-zero funding options available in recent years. While we think that the amount of reserves in the banking system could eventually fall to a point that affects the functioning of overnight lending markets, forcing the Fed to end QT, that level doesn't appear to be close. The prospect of Fed rate cuts, which are probably the most meaningful factor that would reduce the pressure on banks, is also fading further into 2024.

Collaboration Across Asset Classes

The market in regional bank equities takes many of its cues from the market in their debt and vice versa, making the collaboration between equity and debt analysts at T. Rowe Price an essential component of forming a holistic outlook for the industry.

While we believe that much of the solvency risk has been removed from the regional banking sector following some mergers in the industry since March and the Fed's prompt response, a strong rally in the equities has taken away much of the value that existed in healthy individual regional banks that saw their stocks sink after the Silicon

[1] The marginal cost of funds is the incremental increase in financing cost resulting from adding one additional dollar of new funding.

Valley Bank failure. From May 15, which was near the low point for 2023, through August 15, the KBW Regional Banking Index[2] generated a total return over 24%, easily outpacing the 8.1% return of the broad S&P 500 Index.[3]

Similarly, we think that the "left tail" risk of a regional bank defaulting on its bonds is now small, but we also don't see compelling reasons to buy the debt of these banks. Although credit spreads[4] have not narrowed in line with the rally in regional bank equities, the prospect of additional debt issuance to meet the impending higher capital requirements keeps us cautious on regional bank bonds. We also anticipate ongoing volatility in these bonds as the banks continue to adapt to an environment of QT and higher rates.

WHAT WE'RE WATCHING NEXT

We closely monitor flows into money market funds, which can be a proxy for deposits leaving the banking system. With money market yields resetting higher at a much faster pace than interest rates on bank accounts, many depositors have been shifting their short-term cash allocations out of banks and into money market products—and creating liquidity problems for banks. A "higher for longer" scenario for Fed monetary policy will sustain this pressure on bank funding.

[2] Data source: Bloomberg Finance L.P.
[3] **Past performance is not a reliable indicator of future performance.**
[4] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

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