



## US Watch

# IS A SMALL BANK PROBLEM BREWING?

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- **Small banks lent more than large ones & outpaced them in reducing reserve assets at the Fed**
- **Marginal money to fund lending is expensive now that real funds rate is positive and heading higher – includes borrowing at the discount window**
- **An 08-09 banking crisis is not on the horizon but expect a pullback in lending now that small bank capital adequacy ratios are low.**
- **Inflation is financed -- recession still looks more likely than reacceleration**

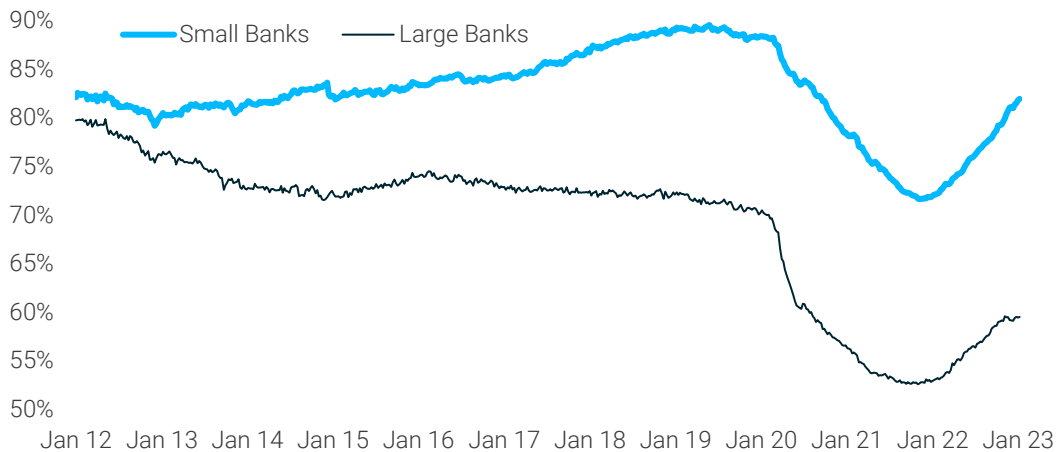
**A problem in small banks is brewing but is unlikely to have anywhere near the financial impact of large bank failures in 2008-09. Percolating problems do, however, mean a cutback in lending and that will slow growth.** The unintended consequence of post-GFC banking re-regulation is that bank risk from weakening credit and funding pressures moved from G-SIBs to small banks. This shift is more likely to have impact in 2023 because financial risks are heightened now that real policy rates are moving ahead of core inflation (on a three-month annualized basis), the yield curve is inverted, and there is measurable negative carry in financial and goods markets. Before significant bank funding problems surface, I would expect banks, small and large, to cut back on extending credit -- cheap funding for loans has dried up. All of which adds to the argument that the economy is heading for a recession, however, mild, more so than a reacceleration. The race doesn't always go to the swiftest or the fight to the strongest, but that's the way to bet.

**The coming cyclical deterioration of credit quality (business and personal) will be most problematic for small banks because they were the more aggressive in lending and in borrowing short-term liabilities to fund themselves (including the discount window at the Fed).**

The Fed defines large banks as the top 25 ranked by size – threshold of \$160 bn in consolidated assets. The rise of small bank lending relative to large banks began in 2013, as Dodd-Frank and macro-prudential regulations and QE constrained large banks. Outstanding small bank loans and leases were 45% of large bank outstandings at that time, the percentage rose to 60% by the end of 2019 and is now 70%.

**Small banks lent more aggressively because, in part, they are more singularly dependent on lending to generate income.** While small and large banks both still have loan-to-deposit below pre-Covid levels, small bank loans and leases are 82% of deposits versus 88% before Covid – large banks are at 60% versus 70% pre-Covid. In 2012, loan/deposit ratios were similar at both banks. (Chart 1).

**Chart 1: Small banks more dependent on loans for income (loans % deposits)**



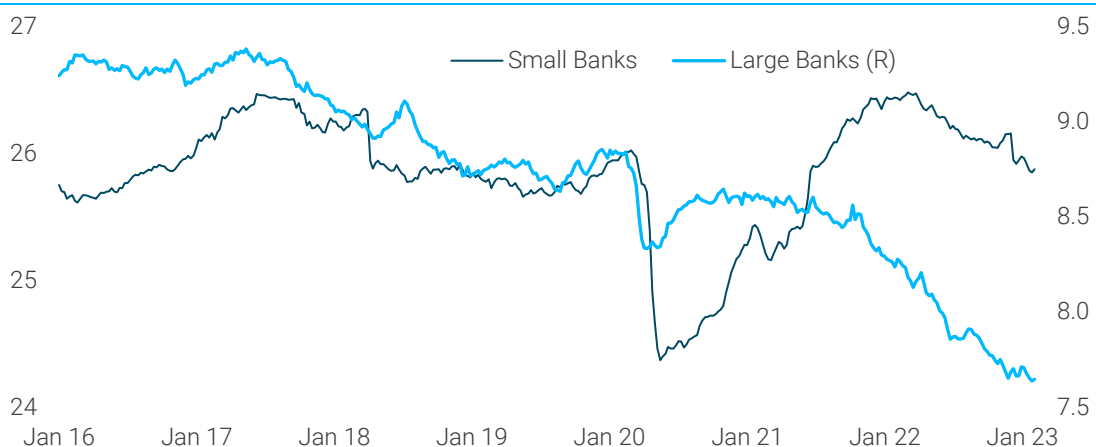
Source: Federal Reserve, TS Lombard

**Credit concerns for small banks in this cycle tie to the general liquidity of their borrowers versus borrowers from big banks, and that small bank lending is far more concentrated in nonfarm non-residential real estate (28%) than are large bank loans (8%)** (Chart 2). Add

farmland and farm buildings to the total, and small bank loans are 35% allocated to commercial real estate as opposed to 11% for large banks. It is no secret that office buildings are a particularly stressed asset at this time, considering reduced occupancy rates in relation to the cap rates assigned when these financing transactions were last made. On a dollar basis, since Covid began, outstanding nonfarm non-residential real estate loans at large banks dropped to \$495 billion from \$515 billion— whereas, at small banks, these loans rose to near \$1.2 trillion from \$900 billion.

**Chart 2: Small banks have the greater concentration of loans in commercial real estate**

% Of loans and leases



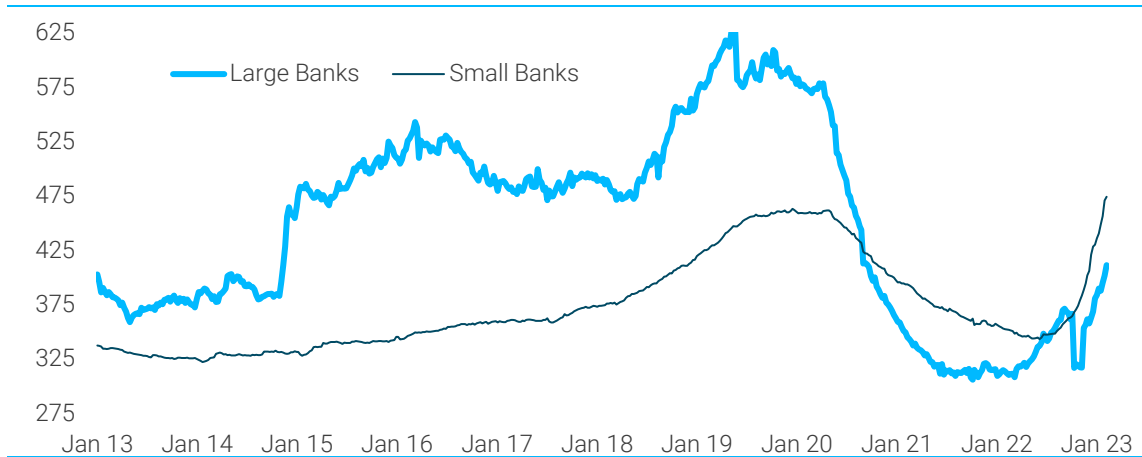
Source: Federal Reserve, TS Lombard

**The funding side for these banks is where the story gets interesting – and troublesome.** To finance loan growth, large and small banks reduced reserve assets at the Fed, increased the volume of large time deposits, and borrowed. The volume of large time deposits at small banks are now larger than the volume at large banks – a sharp reversal from pre-Covid years (Chart 3).

Keep in mind that small banks, in total, have liabilities only equal to 52% of large bank liabilities. Both banks have been buying deposits at a rapid pace in the past year or so, but large deposits at small banks have accelerated more rapidly, in line with increased lending.

**Chart 3: Large deposits at small banks exceed volume at large banks, and are growing faster**

\$ Billions, weekly data

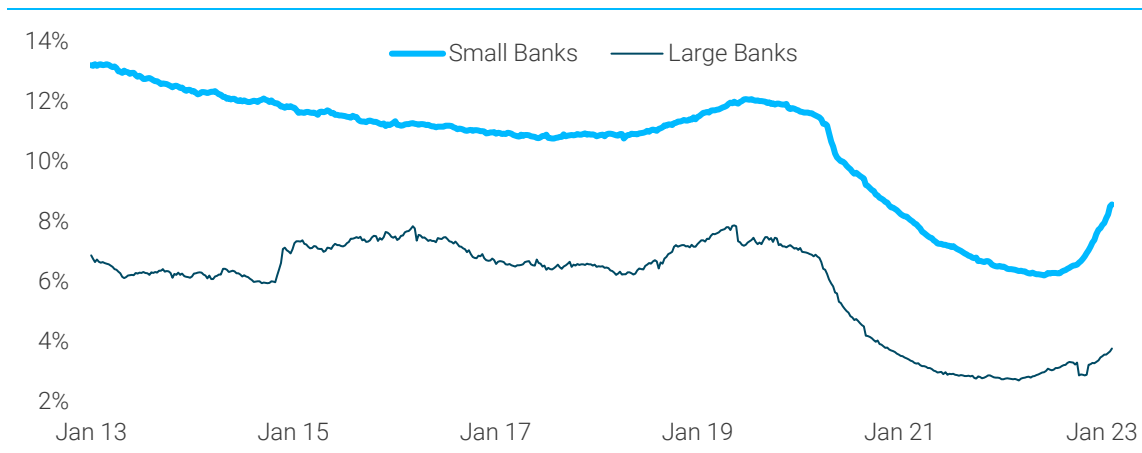


Source: Federal Reserve, TS Lombard

**Small banks have a decidedly greater reliance on purchased deposits** relative to total deposits in comparison to large banks (9% versus 4%) though both ratios are far from pre-Covid levels (Chart 4).

**Chart 4: Small banks greatly boosted their reliance on purchased deposits**

Large deposits % total deposits

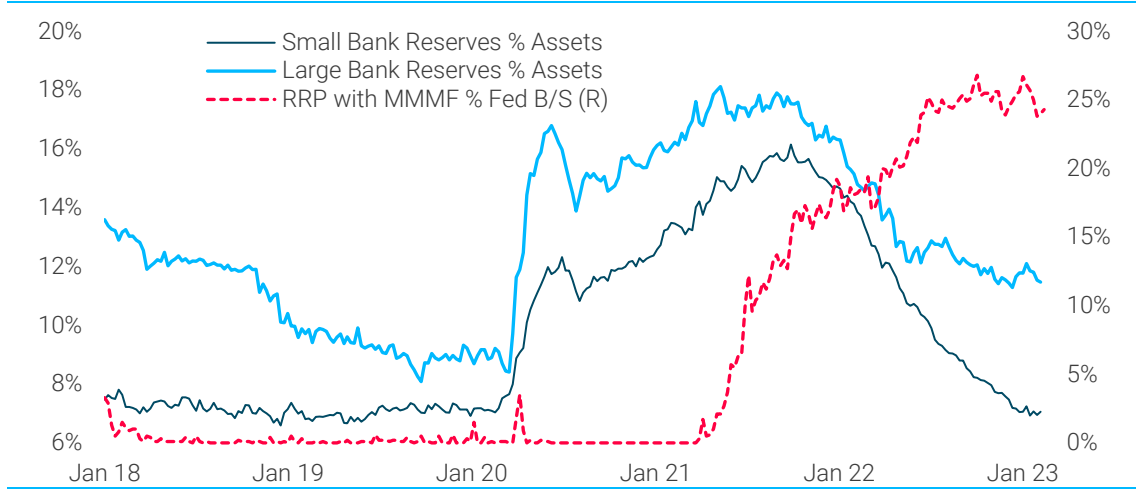


Source: Federal Reserve

**Lending was initially funded by banks actively reducing reserve assets at the Fed, long before QT began (and why RRP with money funds soared)** Banks are now sitting with reserves pretty much at their lowest comfort level –especially small banks (Chart 5). While this has implications for bank behaviour going forward, the implication for the Fed and markets is that RRP will begin to shrink relative to the Fed balance sheet (appears to have topped out). There could, however, be a short reprieve depending on how fast Treasury runs down its balances at the Fed in response to

the debt ceiling (expect a drain this month, smaller one in March, and then an inflow in April when tax payments come due).

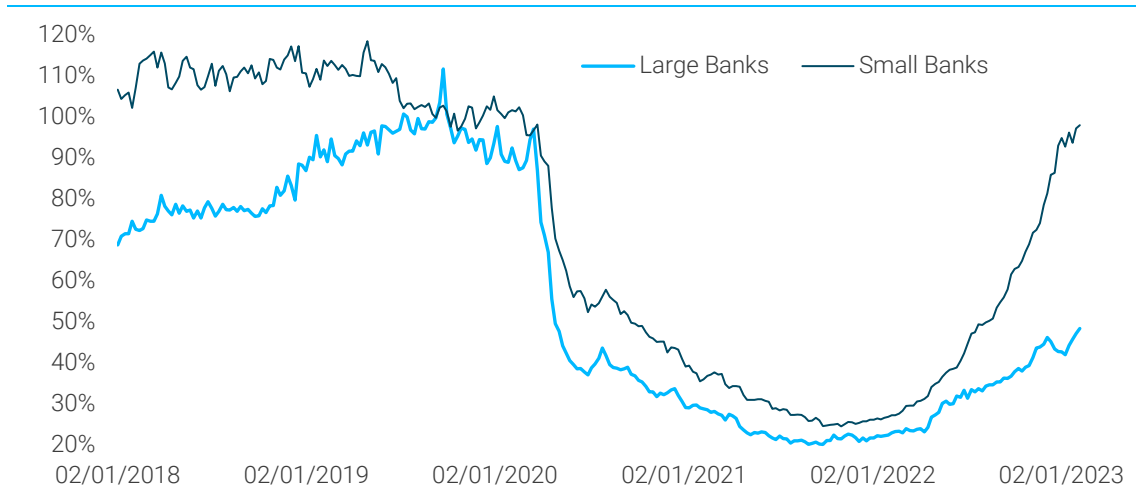
**Chart 5: Small bank reserves are as low as they are going to go, drying up a source of funding for loans**



Source: Federal Reserve, TS Lombard

**Staying focused on the composition of small bank funding, as their level of reserves dropped, borrowings relative to reserves increased sharply,** and is essentially back to pre-Covid levels – far from the case for large banks (Chart 6).

**Chart 6: Borrowings as a % of reserves rising because cash/assets are low, especially for small banks**



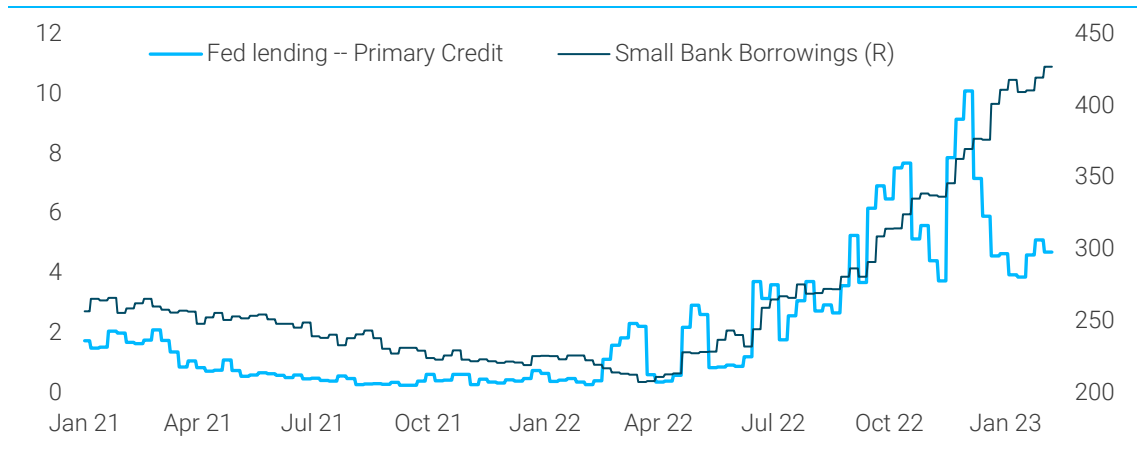
Source: Federal Reserve, TS Lombard

**Low cash-to-asset ratios at small banks have consequently moved them to increase borrowings to fund themselves (Chart 7), including increased use of the Discount Window (DW) at the Fed.** The Fed has worked hard in the past several years to remove the stigma of borrowing from the DW (large banks helped in early 2020 as a show of good faith, not because they needed the money). Part of the Fed’s efforts included eliminating the primary credit penalty rate above the top end of the Fed funds target range and charging the same rate whether the money is for overnight purposes or term (90 days, for example). This is much more competitive

than advances from the FHLB. Small banks, many of whom are private and therefore have no shareholder concerns regarding the optics of borrowing from the DW, have consequently shifted to using the Fed’s DW facility. **There may also be another factor moving banks from the FHLB to the Fed for financing – the FHLB requires positive tangible capital. In 2022, small banks showed a drop in tangible equity capital to total assets, losses on purchased securities being one source of the change in this ratio – although, to be clear, only a tiny number had negative capital as of 2022Q3 call reports.**

**Chart 7: Small banks turn to the discount window as part of their borrowing**

\$ Billions



Source: Federal Reserve, TS Lombard

**Is there a small bank funding crisis in the making?** There is not much of a cash-to-asset cushion left for small banks (as a whole), so a funding crisis can easily get rolling if large depositors, generally uninsured (\$250,000 is deposit cap for FDIC insurance), decide too many loans in commercial real estate and other areas are about to go bad. The Fed will make funds available to keep these banks afloat, the DW writ large, and would eventually merge the weakest small banks into healthier ones. That alone would get some push-back from Congress because of the increased concentration of bank deposits among an increasingly fewer number of banks. This concentration accelerated in 2008-09, when the Fed officiated over many shot-gun weddings to keep the banking system afloat.

**How small banks could possibly have slipped up under the promised macro-supervision radar links to the political direction to lighten the regulatory burden on small, community banks.** The belief is that they should not be subject to the same reporting requirements as, for example, a JP Morgan. **This view was recently espoused by Fed Governor Michelle Bowman, whose portfolio is to represent the needs and requirements of community banks,** said on Feb 13 in a speech at the American Bankers Association Community Banking Conference -- “While I expect the Board will propose new capital requirements for the largest institutions, including the Basel III “endgame” reforms, I do not expect every tier of firms to be subject to the same changes. And my understanding is that there are no plans to propose changes to the community bank capital framework as part of this capital review.”

**In advance of a banking problem rooted in bad loans that turns into a funding problem, banks (small and large) are going to pull back on lending at an even faster pace.** Put simply, inflation is financed. It was financed from January 2020 to June 2021 by a \$5.6 trillion increase in Federal borrowing – bank lending in that period was only up \$326 billion – and Core CPI increased 3.8%.

From June 2021 to January 2023, Federal borrowing increased \$2.9 trillion and commercial bank lending increased \$1.4 trillion and Core CPI increased 7%. All of which is to say that while bank lending has slowed, it is still growing 7% annualized on 12W basis, but it is set to slow further – funding costs are getting higher in real terms and, with that, prospects for favourable returns on new credit are getting lower.

**In sum**, small banks look like they are heading for an unsettling mix of reduced funding and more underperforming loans. While a 2008-09 banking crisis is not going to arrive, the coming acceleration in reducing credit extensions adds to the argument that the economy is more likely to slow than advance in the coming months.