

Following the collapse of Silicon Valley Bank, where do the risks lie for small banks?

We examine the genesis of the gap between bank deposits and loans. Small bank loan books represent a greater proportion of deposits relative to large banks. This is fine and quite different to Silicon Valley Bank. The outsized exposure of small banks is in commercial real estate, so it's better to keep an eye on that than worrying about a deposit flight



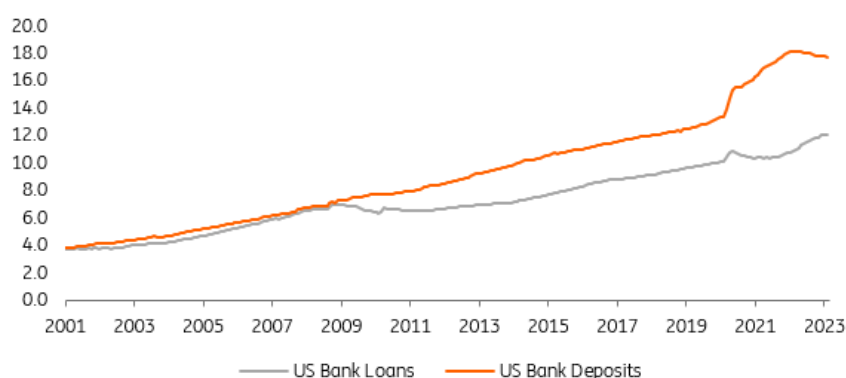
Silicon Valley Bank collapsed last month after there was a bank run on its deposits

A few weeks ago there was concern about a material deposit flight from small banks. A deposit outflow of some US\$200bn occurred in the space of a couple of weeks, representing almost 4% of small bank deposits. But the good news is these outflows seem to have stopped, as last week saw a small build in deposits at small banks. The other sliver of positivity comes from the flat-lining of the take-down of emergency liquidity from the Federal Reserve, now in the area of \$350bn. So we're in a holding pattern, which is a tolerable outcome so far.

As we pan back and examine the balance sheets of US banks, a number of unusual circumstances

jump out. First, US bank deposits are significantly higher than their loan portfolios. This is unusual in the sense that commercial banks take in deposits primarily to write loans against them, thereby benefitting from the difference between the deposit rate and the lending rate. It's clear from the graph below that a significant change occurred as a fallout from the Great Financial Crisis, where on the one hand considerable consumer deleveraging occurred, and on the other the Federal Reserve expanded its balance sheet, pushing significant liquidity into the system through its bond-buying programme.

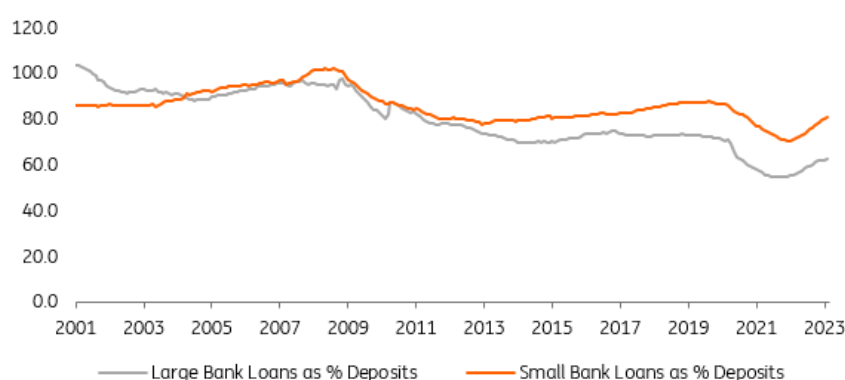
US bank deposits as a base from which to write loans (US\$ tr)



Source: Macrobond, Federal Reserve, ING estimates

The Covid-19 pandemic saw a repeat of this. There was the impact of re-leveraging in the corporate sector as loans were taken down to help build cash positions. On top of that, the Federal Reserve and the Treasury boosted liquidity conditions at a multiple of the pace seen during the GFC, manifesting in a significant build in bank deposits. Such was the rise in deposits that by the middle of 2021 the large banks had loan books that were only 55% of their deposit base. This was a remarkable state of affairs, as typically the loan portfolio has been 90% or higher as a proportion of the loan book. Theoretically, it should be at around 100%, with any deviation taken up by the purchase of securities, which from the point of view of the bank is effectively the same as writing a loan.

Small banks have more loans versus deposits than large banks (%)



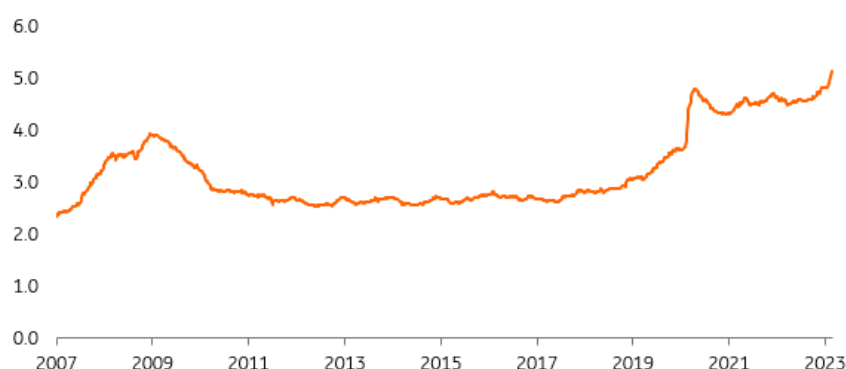
Source: Macrobond, Federal Reserve, ING estimates

That proportion (of loans to deposits) has since risen to moderately above 60%. Silicon Valley Bank had a ratio of loans to deposits of 43% and thus was significantly out of kilter relative to typical banks. Its securities portfolio was a remarkable 68% of deposits, and it was the reduction in the market value of this portfolio that added to consternation as demands were made to withdraw deposits.

And what about small banks? Well, the good news here is that the ratio is far higher – currently, loans account for about 80% of deposits. The ratio of loans to deposits is in fact far more lopsided among the large banks. Importantly, the typical small bank looks nothing like Silicon Valley Bank on this particular metric.

How do we square the circle here? Basically, the excess of deposits over loans is a consequence of the expansion of the balance sheet of the Fed, and the counterpart of this can be found in banks' excess reserve holdings at the central bank. These are remunerated at the fed funds rate plus 15bp (currently 4.9%). Banks can then pay deposit holders at a rate below this to ensure they achieve a suitable net interest margin.

Money market funds have seen significant inflows (US\$ tr)



Source: Macrobond, ICI, ING estimates

Some players had been careful to take deposits out of the banks, moving funds into money market funds to get a better running yield (closer to the 4.9%), well before the recent banking troubles. The demise of SVB gave this an additional push, so much so that in the past few weeks some \$300bn of new money has piled into money market funds.

This does not look like it's becoming a rout. It's more a measured allocation shift where feasible and sensible. It should not really "threaten" the banks. But we still need to monitor it.

Where does this leave the risks for small banks?

Currently, small bank deposits have stabilised following an initial fall. Some 80% of those deposits show up as loans. So the exposure to bond portfolios for small banks is less the case than for large banks. As noted, Silicon Valley Bank had quite a large bond portfolio, which was a problem if mark-to-market (although it did not actually have to be). In that sense, SVB is actually not representative of small banks, at least as typified by this measure.

In any case, such security portfolios are now fully liquefiable at the Fed. We can, or should, relax on this front. A deposit flight is unlikely to happen just for the sake of it. And in any case, deposits are impliedly protected, at least for now.

The breakout of lending, and small bank exposure to commercial real estate

	Total Lending (US\$ trn)	Small Bank Proportion (%)
Commercial Real Estate	2.8	70
Residential Real Estate	2.5	38
Commercial & Industrial	2.3	34
Consumer Lending	1.9	24

Source: Macrobond, Federal Reserve, ING estimates

What about lending books?

The large banks have bigger lending books, both proportionally and in an absolute sense, in residential real estate, commercial and industrial and consumer loans, meaning hits here (should they occur) are less impactful for small banks.

The area where we need to pay attention is small bank exposure to commercial real estate, primarily as they account for some 70% of total lending in this segment; a remarkable statistic that clearly identifies where the real vulnerability may lie. And the post-pandemic implications in this space have yet to be fully played out.

These proportions will change from institution to institution, and some will in any case be stronger and capable of taking more hits than others. But this is the space to watch carefully ahead.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss

arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.