Testimony

Before the U.S. House Financial Services Subcommittee on Financial Institutions and Monetary Policy

Hearing on “Federal Responses to Recent Bank Failures”

Thomas Michaud

President and CEO

Keefe, Bruyette & Woods (KBW), ***A Stifel Company***

May 10, 2023

Good morning, Chairman Barr and members of the Financial Services subcommittee, and thank you for inviting me to speak with you as part of this important hearing.

By way of background, Keefe, Bruyette & Woods (KBW) is a 61 year old firm that specializes in investment research, equity brokerage and investment banking services for financial institutions. Given the firm's breadth of focus, the firm has a unique expertise in understanding not only the largest institutions in the financial services industry, but also the mid and small company universe as well. KBW has one of the most extensive franchises of its kind in the world, with a widely recognized research department, covering more than 450 US financial institutions and approximately 150 European and Japanese institutions.

KBW was an employee owned firm until 2006 when it went public on the New York Stock Exchange. The firm was acquired by Stifel Financial (Stifel) in 2013 and today operates as a subsidiary of Stifel (NYSE: SF). Stifel is a 132 year old company, headquartered in Saint Louis, MO and is the nation's 7th largest retail brokerage firm, based upon the number of registered investment advisors. KBW, once headquartered in the World Trade Center, has been very active in the 911 community. In particular, the firm helped establish 911Day.org (www.911day.org) as an organization that has responded to Congressional action dedicating 911 as a National Day of Remembrance and Service.

I have been with KBW for 36 years and have been President and CEO for the past 11. I started my career as a bank credit analyst before moving to equity research where I specialized in bank research. Over my career, I have been responsible for businesses in the US and Europe. I often represent the firm as an expert on the banking and financial services industry and my views are consistently sought by industry leaders, corporations and journalists. My parent company is also a Member of the Mid-Sized Bank Coalition and I have worked closely with Members of Congress on matters impacting financial services and banking.

Banking crises, driven by depositor fear, have happened before and are why the FDIC was created.

Over the past 150 years, the United States has undergone approximately 10 periods of bank unrest or turmoil. Most of these periods led to a lack of confidence (or were created by a lack of confidence) in the banking system and undermined the ability of banks to perform their essential contribution to economic functioning and prosperity. Or said a different way, what is happening now is not unprecedented, but thankfully only happens about once every 15 years in modern American history. Each of these banking panics has had plummeting confidence as a key element. In 1933, upon the creation of the FDIC and following a bank panic that led to a bank holiday, President Roosevelt said "there is an element in the readjustment of our financial system more important than currency, more important than gold and that is the confidence of the people… You people must have faith, you must not be stampeded by rumors or guesses. Let us unite in banishing fear." While today's banking stress is nothing like the panic in 1933, fear

played a central role in leading to three bank failures over the past two months. These three failures represent three of the four largest in American history.

As many economists see a slowdown and possible recession on the horizon, the nation should know that the fundamentals of the banking industry are sound. The United States has one of the strongest, if not the strongest, banking systems in the world and more than a few of this industry's practices set the global standard. Changes in liquidity and capital requirements following the Global Financial Crisis and as directed by Dodd Frank, have helped position the industry to better weather the pending economic slowdown. However, recent declining depositor confidence has emerged as a critical variable in 2023 and needs to be addressed or the complexion of the industry will change dramatically. While the recent apex of the crisis appears to be behind us, confidence in the banking system remains very fragile and volatility in the stocks and bonds of banking companies continue to exhibit and contribute to this wariness.

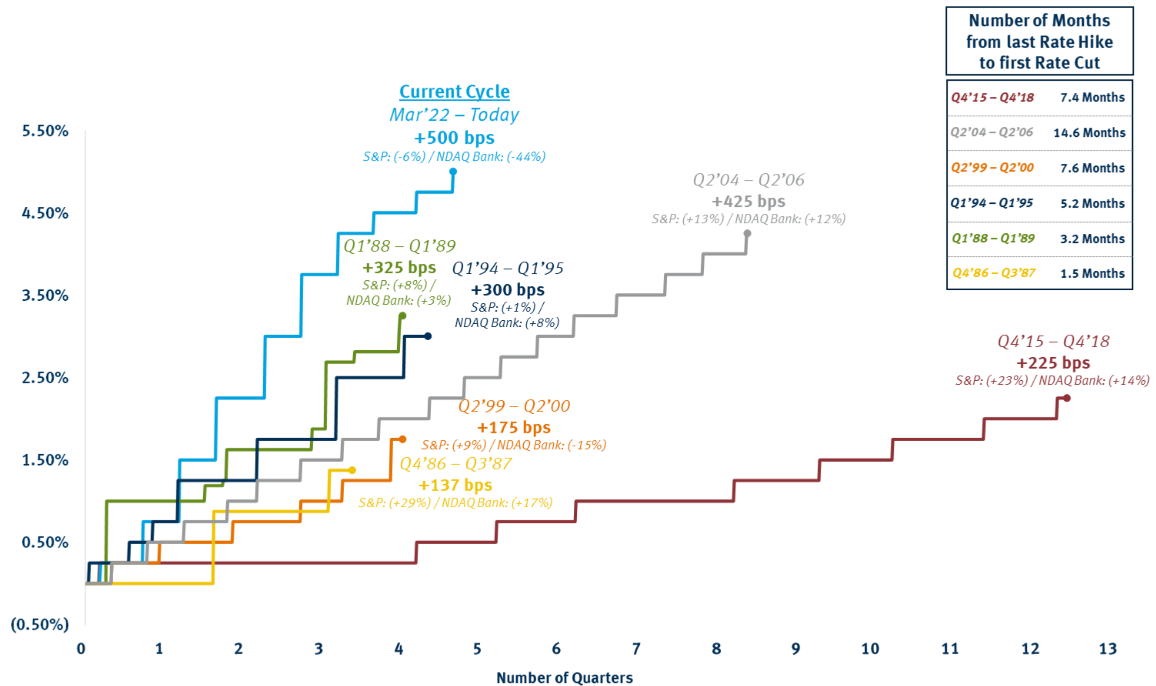
The March bank failures show how the speed of money has accelerated and the impactful role that social media can play.

During Congressional Hearings following the collapse of Silicon Valley Bank it was disclosed that depositors withdrew 20+% of deposits on Thursday, March 9th and had initiated withdrawal requests for 55+% of deposits on Friday, March 10th. If the bank had been open all day it may have, in fact, lost more than 55% of deposits on Friday. The size and speed of this run was unprecedented and reflects the technological advancement that has happened in payments and banking. It is now easier for depositors to move their money between banks than ever before. This increases the chance of a bank run, should a sudden drop in confidence occur. Silicon Valley Bank was primarily a business bank and not a typical bank with branches, and its depositors were more concentrated and larger than a typical bank. Social Media played a role in the bank run when well-known depositors used social networking to communicate that they were withdrawing funds from the bank, and encouraged others to do the same. This might have been the first all-electronic run on a bank of meaningful size. When the FDIC on Friday, March 10th did not protect all of the depositors of Silicon Valley Bank the run quickly spread to other banks. To mitigate risk, depositors took a "who's next" mentality and, increasingly, depositors started to judge the safety of their bank on its size and the degree of its uninsured deposit concentration. This judgement applied particular pressure on mid-sized commercial banks (versus consumer banks), where median deposit balances are larger and included a slightly higher proportion of uninsured deposits. During this period and continuing to today, bank stock volatility has increased significantly with heightened speculation about the health of banks. This market action has further pressured depositor confidence, creating a feedback loop between deposits and stock prices. In the coming months, the Federal Reserve will expand its FedNow real-time payments system. This new program is designed to increase the speed of payments. As these developments roll out, it is critical that the regulatory apparatus and support system for banks keep up.

The recently failed banks had concentrations that made depositors nervous and Held to Maturity Accounting was not a safe harbor during a period of record Fed tightening.

In hindsight, it appears that interest rate exposure is what made Silicon Valley and First Republic riskier in the eyes of depositors. Both banks grew at fast speeds during the pandemic and used the COVID deposit surge to invest in long-dated fixed rate assets, creating a significant duration mismatch on their respective balance sheets. As the Federal Reserve started raising interest rates at a historic pace (see chart below); market commentary, social network communications and volatile stock prices all negatively impacted depositor confidence, which ultimately led to three bank failures. Also, in the case of Silicon Valley Bank, the bank had an unusual degree of concentration in its deposit base, as the top 10 depositors had $13 Billion of total deposits. Suggestions for the future include modifying rules surrounding Held to Maturity securities and placing limits for the use of this accounting treatment as a percentage of bank capital. Or, building in circuit breakers if exposures exceed certain thresholds. Even without regulatory action on this point, I expect market forces to require a greater accounting of concentration in a bank's core business and more limited use of Held to Maturity accounting.

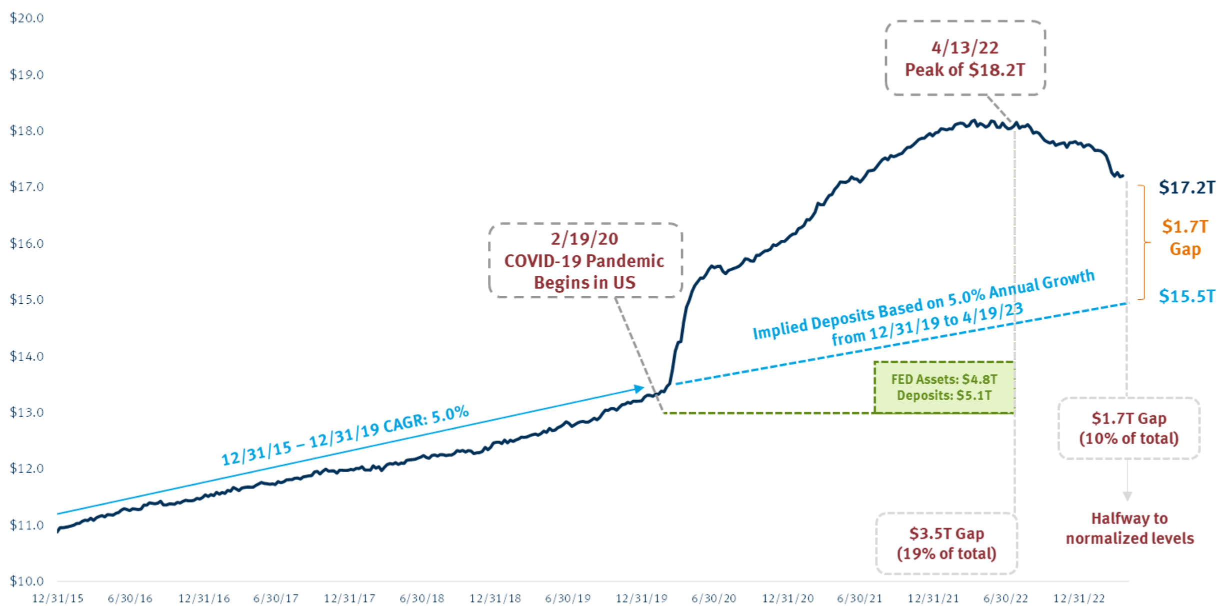
The Fed Has Taken Unprecedented Action to Beat Inflation...



Source: KBW, S&P Global Market Intelligence; Market data as of 5/3/2023
Note: Historical rate hikes since 1985; Rate hikes based on the Fed upper bound

Deposits have been shrinking since April 2022, as COVID surge deposits exit the banking system. This is a headwind for credit extension in the United States.

Industrywide, bank deposits have been a very reliable form of funding for the industry as a whole. Pre-COVID, FDIC deposits were growing at about a 5% annual pace, which makes sense given the pace of GDP growth and the impact of compound interest. As seen in the chart below, the size of the FDIC insured deposit base swelled considerably once the government took necessary monetary and fiscal policy action to offset the impact of the pandemic. Zero interest rate policy, quantitative easing and fiscal stimulus all accounted for this growth in deposits. FDIC insured deposits grew 37% over a 26 month period from February 2020 to April 2022, making it a historic moment in the growth of the nation's deposits. The banking industry had the capital and systems to accept these deposits without any disruption to the economy. Now that government policy has changed, interest rates have gone through the fastest tightening cycle in 40 years and deposits have been declining at a rapid pace. FDIC data suggests that April 2022 was the peak in FDIC deposits during this cycle. Also, if a 5% baseline growth estimate is used, it appears that the percentage of COVID Surge Deposits in the industry peaked at 19% in April 2022 and today stands at 10%, implying that we have more to go for the size of the deposit base to normalize. This is not a perfect science and there are multiple factors that impact this analysis so it will be hard to say exactly how much of the surge deposits are left, but implications are the same. Banks have been managing, and will continue to manage this shrinkage in the deposit base while keeping their institutions sound and open for business. For example, banks have been carrying additional liquidity on their balance sheets and have been raising depositor interest rates in an effort to retain deposits. This is a challenging, but manageable moment in the industry's history. Importantly, having banks fail while COVID surge deposits leave the system only makes the process more challenging. I believe this moment of shrinking deposits and depositor unease, due to the recent failures, is likely to cause banks to be more conservative and this will likely further limit credit availability. This is why I think it is important to increase confidence in the system right now, it will enhance banks' ability to serve their clients and to extend credit more readily as the nation heads into an economic slowdown.



Source: KBW, FRED St. Louis Federal Reserve; Deposit data as of 4/19/2023

The United States needs successful banks of all sizes. The biggest banks have been gaining deposit market share. This trend accelerated in early March, exacerbated by the implicit Too Big To Fail (TBTF) guarantee.

Over the past 12 years and since the largest banks were designated as Systemic as part of the Dodd Frank reforms, the largest U.S. banks have been gaining market share. As of year-end 2022, 3% of U.S. banks have 77% of the industry's deposits, and the nation's largest four banks collectively control 40% of the deposits. Since the crisis began in early March, the trend towards deposits concentrating in the largest banks has accelerated. According to Federal Reserve data, banks have realized nearly $400 billion of deposit outflows since early March. The largest 25 domestically chartered banks have taken less of a hit, with $140 billion of outflows compared to the smaller banks with nearly $240 billion of outflows. It appears that depositors are placing even more value on the implicit guarantee that the largest banks have and that the market share shift is accelerating.

The United States needs banks of all sizes, especially the mid and small sized. Of note, over 60% of the deposits in the country are in banks with over $100 Billion in assets. Yet, these banks don't make 60% of the loans to main street America. Many of these loans are made by mid-sized and smaller banks. Deposit flows to banks based on size will ultimately disrupt the availability of credit in smaller communities. Deposits are the fuel that power loan growth. If the deposits aren't there, then lending capability will shrink, or shadow banks will step in to fill the void. These shadow banks are typically outside any regulatory barrier and supervisors will have less knowledge about what is happening in the credit markets for smaller businesses. As a reminder, close to half of all working Americans are employed by firms that have 100 or fewer employees and

mid-sized banks themselves employ approximately 292,000 people in the U.S. Getting credit to these borrowers is essential for economic growth. Additionally, it is important to recall that it was the mid-sized and smaller banks that drove the government's Payroll Protection Program (PPP) during the pandemic. Statistics show that 60% of the loans distributed were made by community banks. These banks were essential to the program's success and demonstrate these banks' importance to the economy.

While the largest banks in the nation are continuing to grow their market share in the United States, these banks also perform an important role in the global economy, which benefits the nation. Compared to their global peers, the American banks have shown better financial strength which has allowed these banks to better support their clients and the economy. The eight American Global Systemically Important Banks (G-SIBs) dominate the global rankings in fundamental performance of the 28 globally designated G-SIBs. Because of their success, the American banks have had resources to grow and to invest in the future. The largest American banks have been innovators in bringing new technology and products to market. They are also Fintech leaders, which will help ensure that American finance continues to be a global leader. The proposals that I will make later in this written testimony will be to level the playing field between the largest banks in the nation by modernizing FDIC insurance and not by eroding the current success that these banks have had. I believe it is important for mid and small sized banks to not lose market share to these larger banks just because of their size and the implicit counterparty guarantees by the government.

It is also important to allow healthy bank M&A as an important element in strengthening the banking system and allowing banks of all sizes to improve their position via scale. Currently, there are four banks that dominate the landscape with 40% of deposits. Current legislation prohibits banks with more than 10% of deposits to acquire other banks, which is an appropriate policy that should not be altered. The best policy is to allow for mid-sized and smaller banks to combine in order to create more capable competitors. More sufficiently sized regional bank competitors will lead to more choice for banking customers and will power more pricing competition and innovation. Mid-sized banks exist to focus on their local regions and communities. As technology demands grow and the cost of regulation increases with every incremental new rule, mid and small sized banks need the benefit of scale, just like the bigger banks. The marketplace is demanding more services from banks and banks of all size feel pressure to modernize. Consolidation allows for these banks to be more competitive as they grow. With scale, these banks can build the services necessary to compete with the largest banks in their region. Consolidation can also be a tool for regulators to ensure that well run institutions take over banks that need stronger risk management practices, creating a more stable industry overall.

What To Do Now? – Modernize Deposit Insurance Coverage

The last time significant change was made to the deposit insurance limits was when Congress passed the Dodd Frank Act. Since that time the speed of moving money has accelerated and protecting depositor confidence has become more important. Silicon

Valley Bank proved that bank runs can happen fast. No longer will regulators be able to see lines at branches growing, as was the case in previous bank cycles. Also, the nation's biggest banks have grown much larger as a percentage of the industry than what was probably considered when the law was passed. The larger the biggest banks become, the more value depositors will think that they get from the Too Big To Fail implicit government guarantee. Therefore, I think the time is now for modernization of bank deposit coverage. The current deposit insurance system, while successful over the past decades, is an analog system in a digital world. I believe the right answer is in the Targeted Approach as was submitted in the FDIC policy response report on May 1. I support the following for consideration:

1. **Raise deposit account coverage limits**
   Operating accounts (also known as transaction accounts) are the life blood of businesses and non-profits. These are the accounts that entities use to fund payroll and run their businesses on a daily basis. These are the entities that understand their fiduciary obligation to keep their deposits safe and many of them do not have the skills to perform credit analysis on their banks (please recall that both Silicon Valley Bank and Signature Bank were both Investment Grade rated when they failed). For this reason, to enable mid-sized banks to compete more fairly, I support raising the insurance limit for transaction accounts. Congress may also wish to consider increasing the general account limit as well.

2. **Allow additional purchases of FDIC insurance by banks**
   I propose that banks be given an opportunity to purchase additional coverage for other accounts they feel is necessary. Currently, banks are using private sector solutions to establish joint ventures with other banks to maximize deposit coverage. This is done to level the playing field with larger banks, but has added friction to the client relationship and additional cost to the bank. A more direct solution to level the playing field with larger banks is to allow these banks to buy extra insurance from the Deposit Insurance Fund for a fee. This would be in addition to raising the transaction account insurance limit.

3. **Further tailor deposit premiums by size**
   I propose further tailoring deposit premiums to place more of the annual premium on the largest banks that benefit from the Too Big To Fail implicit guarantee. The biggest banks enjoy significant benefits and advantages from this implicit guarantee, and should pay increased insurance premiums to compensate for this guarantee.

4. **Consider new rule change**
   I would investigate limiting Held to Maturity amounts as a percentage of capital or to put in place supervisory limits where regulators will take action to require additional capital if an unrealized loss in a HTM portfolio pierces a certain threshold. I believe this authority already rests with the supervisors and does not require Congressional action.

Conclusion

In conclusion, I would like to leave the Committee with the following points…

- The banking industry is sound, but depositor confidence has been shaken.

- Technology has allowed deposits to flow faster, making bank runs more rapid. As witnessed this past March, bank runs can be contagious, and both depositors and public markets investors tend to look for the next weakest bank when a bank run happens.

- TBTF is real. It is an implicit guarantee that the biggest banks enjoy. A fix for this is to modernize deposit insurance to allow mid and smaller sized banks to compete on equal footing.

- Modernizing deposit insurance will also create additional stability that will enhance the banking industry's ability to raise capital. The proposals discussed today should not change the industry-funded nature of the Deposit Insurance Fund.

- Act now or depositors may redesign the industry while reform is pending. Mid-sized and community banks play an important role at the local and regional level.

- Recognize the difference in the Moral Hazard that exists between Depositors and Investors. Moral Hazard is risky for investors because investors typically lose everything when a bank fails. Don't make depositors feel the same way or they will gravitate to the larger banks due to the implicit guarantee. Small businesses and consumers don't typically have the resources to perform credit analysis on their banks.

- Healthy bank M&A can be a productive process to build more capable regional banks and to fold underperforming banks into stronger banks.

Thank you again for the opportunity to share KBW's views as part of the Subcommittee's May 10, 2023 Hearing.