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Is the US Banking System Headed Toward Catastrophe?

- Carol Roth

In this informative newsletter, Carol covers the alarm bells being sounded by the FDIC and academics; Key stats on uninsured domestic deposits and mark-to-market assets; how at least one of the big banks may be at risk of insolvency; why foreign deposits may be an issue as well; how to prepare for what's ahead; and more.

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It's not just the small and regional US banks at risk.

A couple of weeks ago, during a meeting with the CEOs of the biggest US banks, Treasury Secretary Janet Yellen reportedly said that more "bank mergers" may be required to stabilize the industry, with "mergers" being a fairly disingenuous framing for the current state of affairs. It was also a big hint that the collapses and consolidations that have plagued larger regional banks throughout the spring may not be near an endpoint.

And it's not just the smaller banks that are at risk. The big banks are contending with major issues as well, per recent reports coming out of the FDIC and academia, creating the backdrop for a potential catastrophe.

This creates a real urgency for individuals to hedge against this and other risks, using alternative assets, including physical metals, such as gold and silver.

One issue relates to uninsured deposits. Coming out of the Great Recession Financial Crisis, uninsured domestic deposits became less of a percent of overall deposits in the banking system. However, that shot back up again after a few years. A recent FDIC report, "Options for Deposit Insurance Reform", shared that uninsured deposits had shot up to 43% of overall domestic deposits by the end of 2022.

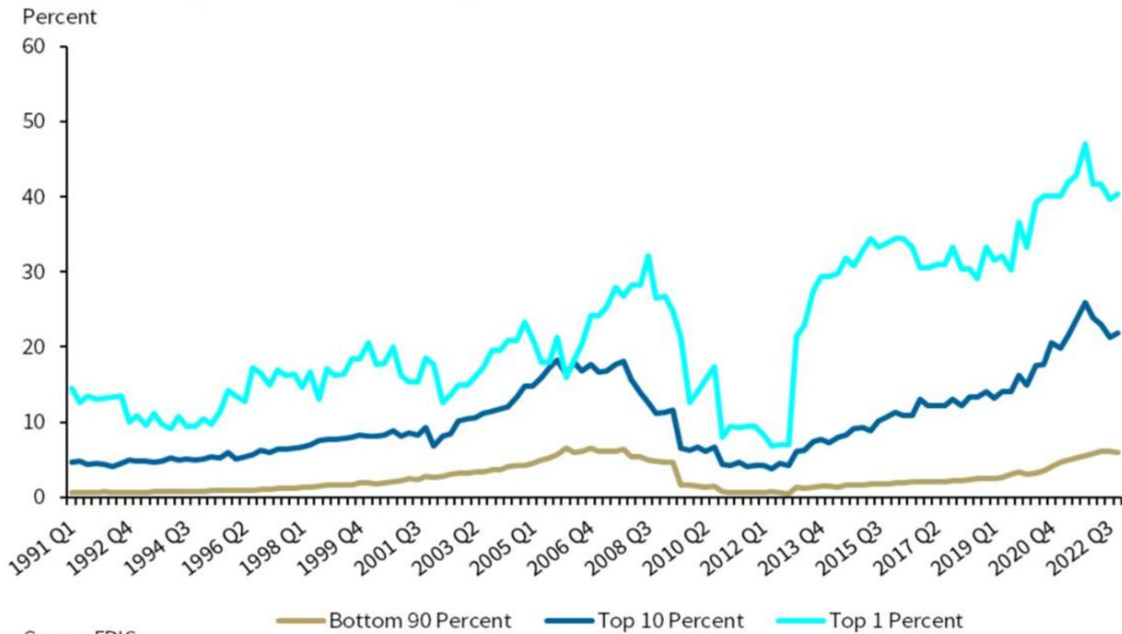
In dollar terms, this means at the end of last year, there was approximately $7.7 trillion in uninsured domestic deposits in the US banking system. See the chart below from the FDIC report.

Figure 2.1 Uninsured Deposits Are Growing as a Share of Domestic Deposits

Source: FDIC.
Note: Figure shows the estimated share of all domestic deposits that are uninsured.

The piece also noted that, “the trend has been most pronounced among the largest banks. Growing concentrations of uninsured deposits at large banks make the banking system potentially more vulnerable to depositor runs such as those in March 2023.”

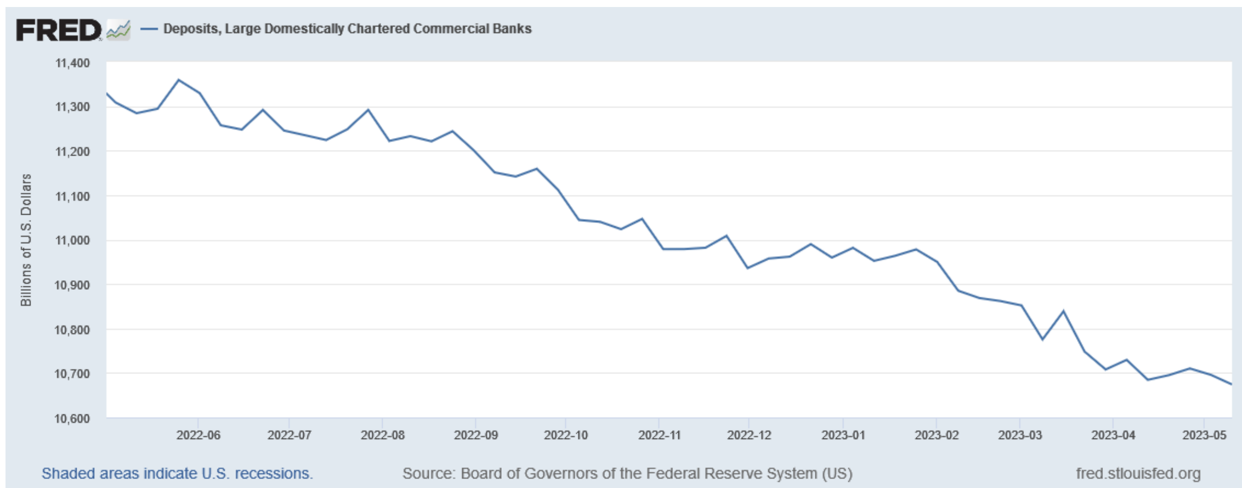
Let me underscore that for you. The banks we believe are the most stable are being called out by the FDIC as having a larger percentage of uninsured deposits. They are projecting that not just the regional banks, but the largest banks are subject to depositor runs. See the chart below from the FDIC report.



Wall Street on Parade analyzed the big banks' year-end holdings and found that more than 40% of the uninsured deposits were held by the big four banks (Bank of America, Citi, JPMorgan Chase and Wells Fargo).

And, while it may seem like these big banks have been the beneficiaries of the consolidation from the regional bank fallout, cherry picking or receiving assets fleeing from smaller banks, these big banks are not immune to their deposits leaving either. It's not just the fear of insolvency that is driving depositors to move their money out of banks, it's the seeking of a better return on their money. Given the substantial shifts in Fed policy rapidly increasing rates, investments like T-bills and the money market, in many cases, provide superior return opportunities for cash than what can be realized from bank deposits.

Thus, the big banks have seen their share of deposits leaving their banks. You can see, per Federal Reserve data, the decline in deposits over the past 12 months, as Fed interest rates continued to rise.



Looking at a variety of analyses, the biggest banks seem to also be losing around the same amount of deposits on a percentage basis as the smaller banks.

However, when looking at systemic risk, the deposit side is only part of the story. Obviously, the larger banks generally have more scale, better-diversified business models and may not have the same mark-to-market (paper) losses of assets on their balance sheets, the latter which creates issues if they are needed to be liquidated early to pay back depositors who want to remove money from the banks.

But that doesn't mean the big banks aren't facing issues.

A study updated in April and completed by professors from Stanford, Northwestern and elsewhere (three who also worked at the National Bureau of Economic Research) called "Monetary Tightening and U.S. Bank Fragility in 2023: Mark-to-Market Losses and Uninsured Depositor Runs?" drew some highly concerning conclusions.

They found that across the banking system, assets, if marked-to-market (i.e., the estimated value they would retrieve if liquidated today instead of held to maturity), would be around $2.2 trillion lower than the value they are carried at on the banks' books. Again, this isn't a problem necessarily if held to maturity, but it does create a risk if they need to be liquidated and are not hedged (which the study notes that most of the assets are not).

To assess what that means for individual banks, the study looked at individual banks (anonymized for the presentation) and each bank's decline in asset values when marked-to-market as well as their percent of uninsured deposits as a proxy for measuring risk. As noted, some banks may have more mark-to-market declines but not much in terms of uninsured deposit risk and other banks may have high uninsured deposits but less exposure in terms of mark-to-market declines.

The concern happens when the large uninsured deposit risk and large mark-to-market risk happen in tandem, as was the case with Silicon Valley Bank.

The authors explain that “a bank’s survival depends on the market beliefs about the share of uninsured depositors who will withdraw money following a decline in the market value of bank assets. If interest rate increases are small such that the bank’s decline in asset values is relatively small, there is no risk of a run equilibrium. However, for sufficiently high increases in interest rates, we have multiple equilibria in which uninsured depositor run making banks insolvent (i.e., a ‘bad’ run equilibrium) becomes a possibility.”

In doing their analysis, they found that not only are a slew of banks at risk of a run that would make them insolvent, but one that they identify at risk is a bank with more than $1 trillion in assets—meaning one of the largest banks in the banking system.

The implications are severe. Having large regional banks go under could cause shocks throughout the system. Having one of the major banks have a bank run and be at risk increases that probability exponentially.

Pam and Russ Martens, from Wall Street on Parade, who helped shed light on this study, contacted the authors to identify which of the anonymized big banks was the one most at risk, but the authors would not say. The Martens said, **“**Short sellers will, undoubtedly, drill down in the regulatory data filed by the four banks to determine the name of the bank in the study, so federal regulators and Congress need to move this issue immediately to the top of their banking crisis priority list.” I have my guess at which two may be the most vulnerable, but as I have not done the supporting deep-research dive, I will keep that to myself.

The issue here is one of perception. If the public at large, including those with uninsured deposits believing the big banks remain “too big to fail” has their confidence shaken, that could shock the entire banking system.

The big banks also hold a substantial amount of “foreign deposits”—that is deposits held outside of the US. These are also not FDIC insured. While the local country might provide some level of insurance, this creates another potential risk that not many are focused on.

As I mentioned in a previous newsletter, banks haven’t yet run up against commercial real estate as an issue. Various analysts and investors are starting to sound the alarm bells, including Morgan Stanley. The CIO for Morgan Stanley Wealth Management, Lisa Shalett, published a recent report saying, "Commercial real estate, already facing headwinds from a shift to hybrid/remote work, has to refinance more than half of its mortgage debt in the next two years."

In terms of the office sector, CNBC reported that “Almost a quarter of mortgages on office buildings must be refinanced in 2023, according to Mortgage Bankers’ Association data.”

This is an issue for the industry, whose participants have to deal with the one-two punch of substantial vacancies, which drives down property values, and higher interest rates (assuming with the degrading conditions of both office buildings and banks, that debt even can be refinanced).

I share all of this with caution. We certainly do not want to see the banking system implode or face serious chaos, and the more concern over the problems that are clearly rooted in the system on the back of bad Fed and government policy, as well as regulatory issues and bank management, the riskier it becomes, as the system is very much built on faith at its core. However, we also don’t want to ignore the

issues and be caught flat-footed or be surprised, given the clear issues that are pervasive throughout the system.

As always, it is important to evaluate your accounts to ensure you are within current FDIC insurance limits (or NCUA limits if you are at a credit union) and also SIPC limits for securities that you may have within financial institutions. This is especially important for small businesses and others who may have larger amounts on deposit to pay payroll or manage operations, or for those of you who are fortunate enough to have developed a substantial portfolio.

More bank chaos would be a catalyst for having more assets considered to be “safe havens”. That includes gold and other precious metals. I personally suggest physical gold, as “paper” gold has its own set of systemic risks.

If you haven’t had an opportunity to hedge your own portfolio, or haven’t hedged enough, consider giving my friends at Goldline a call to help you (they are the only place from which I personally get my precious metals).

And don’t wait on this; hedges should be continually evaluated and adjusted on an ongoing basis, dependent on your current portfolio, your risk tolerance, your objectives and of course, the changing economic backdrop.

It’s clear that much needs to be done to fix the banking system. Unfortunately, the government and the Fed have been enablers of more risk, so it’s unlikely that they are going to be creating meaningful solutions any time soon. Understand the risks this could cause for you personally and take urgent action now to protect yourself and your hard-earned wealth.

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