SPEECHES

Statement by FDIC Chairman Martin J. Gruenberg at the 2023 Community Banking Research Conference

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Good afternoon. It is a pleasure to address this year's Community Banking Research Conference. I want to begin by commending the organizers for once again bringing community bankers, researchers, and policy makers together in what I believe is a one-of-a-kind venue that we are proud to co-sponsor, along with the Federal Reserve and the Conference of State Bank Supervisors.

We are celebrating the 90th anniversary of the establishment of the FDIC this year. The Community Banking Research Conference is an example of the important role that research has played at the FDIC since the FDIC was created by the Banking Act of 1933. In fact, in the FDIC's first full year of operation in 1934, the FDIC Board established the Division of Research and Statistics. During that first year, and amid extraordinary banking stress, the Division developed data on the condition of 93 percent of licensed commercial banks in the United States, conducted a study of depositor losses from 1865 to 1934, and analyzed efforts to stabilize the banking system. Ninety years later, the FDIC remains similarly reliant on and committed to high quality bank data, analysis, and research to inform our important work of maintaining the stability of the banking system and financial sector.

Conferences like this one play an important role in advancing these research efforts and stimulating discussion on important policy issues. I am pleased to see that the papers in this conference tackle important issues for today's community banks: from interest rate risk and depositor runs, to the effects of extreme weather events and the assessment of credit risk.

Bank Failures

As I am sure this audience is aware, on March 10, 2023, Silicon Valley Bank (SVB), of Santa Clara, California, with $209 billion in assets at year-end 2022 and a 90 percent reliance on uninsured deposits, was closed by the California Department of Financial Protection and Innovation, which appointed the FDIC as receiver. The failure of SVB, combined with an announcement by Silvergate Bank two days earlier that it would wind down operations and voluntarily liquidate, signaled the possibility of a contagion effect on other banks. Consistent with contagion concerns, on Sunday, March 12, 2023, just two days after the failure of SVB, another institution, Signature Bank, of New York, New York, with $110 billion in assets at year-end 2022 and also a nearly 90 percent reliance on uninsured deposits, was closed by the New York State Department of Financial Services,

which also appointed the FDIC as receiver. Amid signs of stress at other institutions, concerns grew about further contagion and economic spillovers.

After careful analysis and deliberation, the Boards of the FDIC and the Federal Reserve voted unanimously to recommend, and the Treasury Secretary, in consultation with the President, determined that the FDIC could use emergency systemic risk authorities under the Federal Deposit Insurance Act to fully protect all depositors, including uninsured depositors, in the resolution of SVB and Signature Bank.

Less than two months later, on May 1, 2023, First Republic Bank, of San Francisco, California, was closed by the California Department of Financial Protection and Innovation, which appointed the FDIC as receiver. At year-end 2022, First Republic Bank held $213 billion in assets and had a nearly 70 percent reliance on uninsured deposits. Unlike Silicon Valley Bank and Signature Bank, First Republic Bank was resolved via a purchase and assumption agreement by JPMorgan Chase Bank, National Association, Columbus, Ohio which assumed all of the failed bank's deposits and substantially all of the assets. Since this was a least cost bid, there was no need to consider a systemic risk exception.

Community Bank Resilience

Community banks have proven to be quite resilient during the recent period of stress. The initial performance reports from less than a month after the March failures showed that community banks' net income declined by 4.2 percent in the first quarter of 2023 relative to the previous quarter, as reductions in net interest income and noninterest income were higher than decreases in provision expense and noninterest expense.[1] Even with this decline, first quarter community bank net income exceeded the prior-year quarter.

At the end of the second quarter, community banks reported an increase in net income of 3.4 percent from the prior quarter, as higher noninterest income and lower losses on the sale of securities more than offset lower net interest income and higher noninterest expense. Community bank net income was again improved relative to a year prior. During the second quarter, community bank loan growth continued and was broad-based across most portfolio categories, deposits held fairly steady even as larger banks experienced deposit outflows, and asset quality metrics remained generally favorable.

Despite the generally strong performance of community banks, significant downside risks remain. The net interest margin at community banks fell 10 basis points from the first quarter to 3.39 percent as increases in funding costs continued to outpace increases in loan yields. Compared to the industry as a whole, in the second quarter of this year community banks continued to report a higher proportion of assets with maturities longer than three years. Concentrations of long-maturity assets have held back asset yields and given rise to unrealized losses. And, in regard to credit quality, the significant upward movement in interest rates and shifts in work patterns has created challenges for commercial real estate, most notably office properties. The high interest rate environment and uncertain economic outlook underscore the need for vigilance and careful risk management.

Lessons Learned

In this regard, the bank failures earlier this spring were a reminder that potential vulnerabilities can quickly become real. They have highlighted a number of important policy issues that need to be addressed.

I believe an important lesson of this experience relates to the role of uninsured deposits in the banking system. As I mentioned, SVB, Signature, and First Republic were primarily funded by uninsured deposits, which made them more susceptible to runs. It is important to reexamine the stability of uninsured deposits in the wake of these bank failures and the role that regulation and supervision may play in mitigating the liquidity risks.

The speed with which depositors withdrew funds at the failed banks also merits consideration as we consider our role in promoting financial stability with today's technology. On March 9, the day preceding the failure of SVB, depositors at SVB withdrew $42 billion. $100 billion were scheduled to be withdrawn the next day if the bank had not been closed. Signature Bank lost 20 percent of its deposits on March 10, heading into the weekend of its failure. The ease with which deposits can run and the ability of social media to amplify panic pose significant challenges to regulators in their ability to respond to bank runs.

Another common vulnerability in the failed banks was the maturity mismatch of assets on the balance sheet and exposure to interest rate risk. As the federal funds rate increased from near zero at the beginning of 2022 to more than 400 basis points by the end of the year, long-term securities held on bank balance sheets declined in value. The decline in value was accounted for on bank balance sheets as unrealized losses, but for the three failed banks, and for most other banks, unrealized losses do not affect regulatory capital. Although interest rate risk is not new, the failures have highlighted important questions about how banks are currently managing their interest rate risk. It also raises questions about the appropriate treatment of unrealized losses for capital purposes. The newly proposed Basel III capital rule would begin to address this issue by requiring that unrealized losses on the balance sheets of banks with assets over $100 billion be recognized in the capital of the banks.[2]

SVB, Signature and First Republic also grew their assets rapidly in the years before failure. Rapid bank growth is often a signal of risk taking and their failures merit a re-examination of the connection between asset growth and risk.

In addition to these topics, the bank failures in Spring 2023 have generated significant interest in the appropriateness of the current design of the deposit insurance system in today's environment. In response, on May 1, the FDIC released a report "Options for Deposit Insurance Reform." I encourage you to go to our website and read it, if you have not already done so.

I will spend most of remaining time discussing this issue and the findings of the report.

Deposit Insurance Reform and the Role of Research

Options for Deposit Insurance Reform is an effort to place the events of Spring 2023 in the context of the history, evolution, and purpose of deposit insurance since the FDIC was created in 1933. The report discusses three options to reform the deposit insurance system, as well as the tools that may complement possible reforms.

The primary objectives of deposit insurance are to promote financial stability and protect depositors from loss. The business of banking, which accepts deposits that are available on demand while making long-term loans, remains susceptible to runs. Deposit insurance provides assurance to depositors that they will have access to their insured funds if a bank fails, thereby reducing the risk of bank runs. As of December 2022, more than 99 percent of deposit accounts were under the 250,000 dollar deposit insurance limit.

The report highlights that while the overwhelming majority of deposit accounts remain below the deposit insurance limit, growth in uninsured deposits has increased the exposure of the banking system to bank runs. At its peak in 2021, uninsured deposits accounted for nearly 47 percent of domestic deposits, higher than at any time since 1949, although less than 1 percent of deposit accounts. Uninsured deposits are thus held in a small share of accounts but can be a large proportion of banks' funding, particularly among the largest banks by asset size. Large concentrations of uninsured deposits increase the potential for bank runs and can threaten financial stability.

While deposit insurance can promote financial stability by reducing depositors' incentives to run, it can also increase moral hazard by providing an incentive for banks to take on greater risk. Banks practicing sound risk

management incorporate the risks associated with deposit withdrawals into their decision making.

Before discussing changes to the deposit insurance system, the report highlights that the effectiveness of deposit insurance depends on how it interacts with other aspects of the banking regulatory system. Regulation and supervision play an important role in supporting the financial stability objective of deposit insurance and limiting risk-taking that may result from moral hazard. Capital and liquidity requirements, as well as supervision of interest rate risk management, rapid asset and liability growth, and concentrations of uninsured deposits are important examples. The report also discusses new tools that might be considered to complement deposit insurance system reforms such as a requirement that banks maintain an amount of long term debt to absorb losses ahead of uninsured deposits.

The report evaluates three options to reform the deposit insurance system: maintaining the current structure of Limited Coverage, including the possibility of an increased but clearly delineated deposit insurance limit; Unlimited Coverage of all deposits; and Targeted Coverage, which would allow for higher or unlimited coverage for business payment accounts.

Of these options, the report identifies Targeted Coverage as having the greatest potential for meeting the fundamental objectives of deposit insurance relative to its costs. Business payment accounts may pose a lower risk of moral hazard because those account holders are less likely to view their deposits using a risk-return tradeoff than a depositor using the account for savings and investment purposes. At the same time, business payment accounts may pose greater financial stability concerns than other accounts given that the inability to access these accounts can result in broader economic effects from the failure to make payrolls that might be mitigated by higher deposit insurance coverage. The report points out that providing a practical definition and ensuring that banks and depositors cannot circumvent those definitions to obtain higher coverage are important for the effective implementation of Targeted Coverage.

Conclusion

I would like to thank the Federal Reserve Bank of St. Louis and their outstanding administrative and technical teams for hosting the conference. I also want to thank the conference organizing committee, led by Jim Fuchs of St. Louis with members from the Federal Reserve System, the Conference of State Bank Supervisors, and the FDIC, for the outstanding conference agenda.

Additionally, I thank the presenters, discussants, and panelists whose research and insights are the reason this conference occupies an important place in the field of banking research.

The events of Spring 2023 raised a number of important policy issues. The existing body of research has already been influential in shaping the analysis and thinking on these issues. Yet, there remain many open questions to address. I encourage all of you to continue working to inform our understanding of these issues and their impact on community banks, the banking system as a whole, and bank regulation.

[1] Growth in net income and other statements about growth in dollar amounts are adjusted for the effects of mergers.

[2] Specifically, the proposed rule would require covered institutions to reflect unrealized gains and losses on available-for-sale securities in regulatory capital.

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