

Deposit flight fears grow at regional banks as Fed warns of credit squeeze

Article

The news: The US banking system remains “sound and resilient,” according to the Federal Reserve, despite warning that recent turmoil could lead to a credit squeeze and a “marked slowdown in economic activity.”

- The biggest risks to financial stability are persistent inflation, tighter monetary policy, banking-sector stress, and real estate pressures, the central bank outlined in its [Financial Stability Report](#).
- The Fed also found that lenders plan to tighten lending standards over the rest of 2023 due to concerns about bank funding costs, liquidity, and deposit outflows, per its quarterly [Senior Loan Officer Opinion Survey](#). In the past three months, **45.1% of large and middle-market banks** said they've already tightened lending conditions.

Three takeaways:

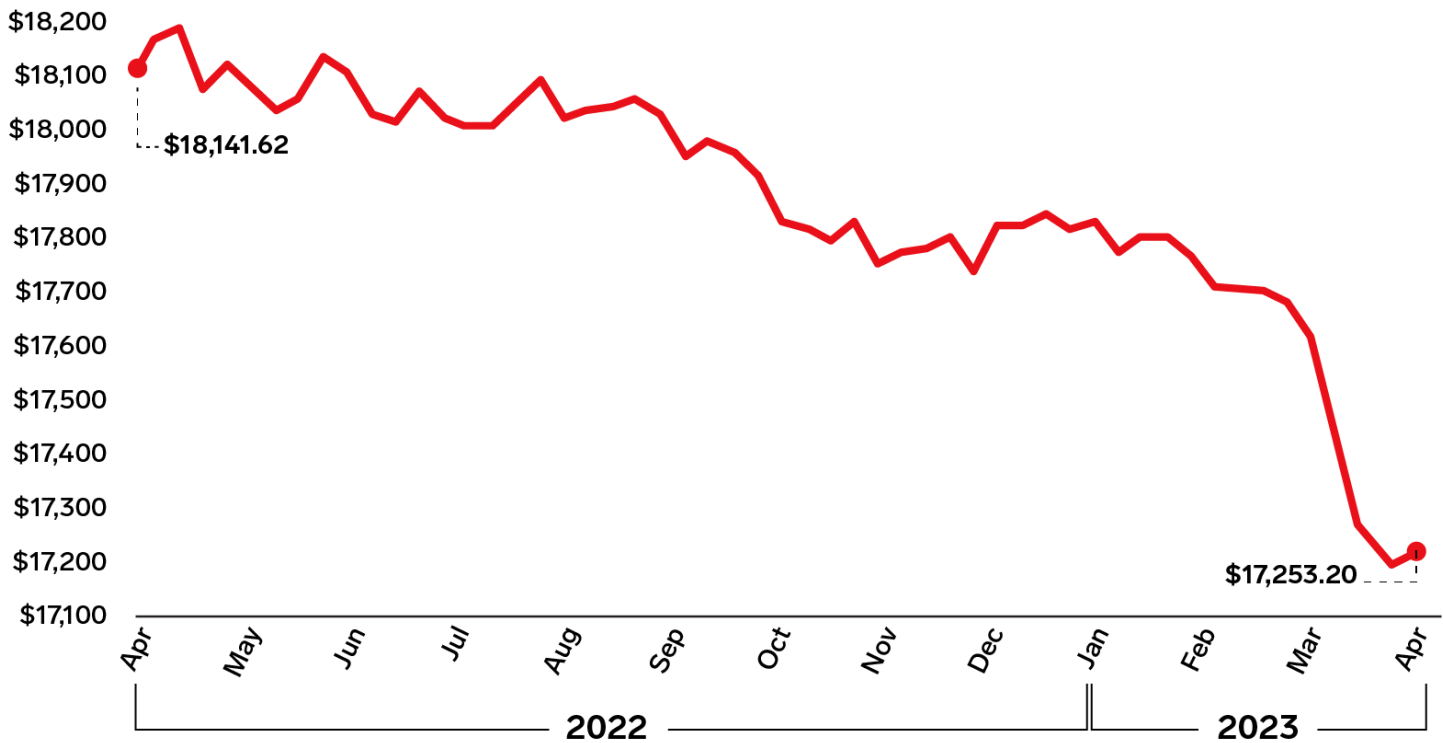
1. **Smaller banks are most at risk.** They were more likely to list concerns over liquidity and funding costs as reasons for cutting lending, indicating they're more worried about fallout from regional bank failures. Midsized banks remain vulnerable to [social media-led deposit flights](#), which could force them to raise rates on savings accounts, squeezing profits. Stricter regulations and dented consumer trust will also be key concerns.
2. **The Fed has confidence in the system.** Compared with 2008, the US banking sector has so far held up relatively well, and regional bank collapses haven't harmed major lenders. The Fed stressed that "banks have ample liquidity and limited reliance on short-term wholesale funding." Post-2008 reforms mean banks, especially systemically important institutions, are far better prepared to weather market problems than during the financial crisis.
3. **Banking turmoil could spread.** The Fed singled out several sectors with "structural vulnerabilities" that could be badly hit by economic problems, including money market funds, stablecoins, and hedge funds. Weaknesses in the commercial real estate sector mean it could also be vulnerable to banking sector turbulence.

What next? New legislation and tighter oversight should better protect regional banks going forward—although that could intensify the lending squeeze.

And last week, the Fed raised interest rates but hinted the rapid series of hikes could be coming to an end. Pausing the rate increases could offer banks some much-needed breathing room and help head off any more deposit flights.

Deposits, All US Commercial Banks, April 2022–2023

billions



Source: Federal Reserve Bank of St. Louis

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