Lazy Banking and the Impending Risk of Zombie Lending

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In many emerging markets, public sector banks receive deposits merely by the status of being backed by their governments and usually regardless of their true underlying efficiency. In fact, the banks might be even undercapitalized and yet depositors seek the safety and security offered by the government backing. Such, possibly undeserving, influx of deposits leads to "lazy banking", a term coined by Dr Rakesh Mohan, the former Deputy Governor of the Reserve Bank of India.

The model of lazy banking is to be passive recipients of deposits and simply invest them in government securities, hoping to earn "carry" and mark-to-market gains on "available-for-sale" portfolio if interest rates decline, and then seeking accounting dispensations or capital forbearance from the regulator when rates rise so as to hide losses by moving securities into the "hold-to-maturity" portfolio. This way, lazy banks ride up and down with the interest rate cycle, becoming undercapitalized when rates rise, and choking credit to the real economy, precisely when it is tough-going for the borrowers. Worse, lazy undercapitalized banks, once granted regulatory or accounting forbearances, evergreen their distressed borrowers, resulting in a zombification of the real economy and sclerosis of its healthier parts.

The failures of Silvergate, Silicon Valley Bank (SVB), Signature Bank and First Republic Bank in the United States (US) over the past three months has many shades of lazy banking. There are parallels as well as differences, as when it comes to financial fragility, history usually rhymes rather than repeats itself.

First, these banks grew at a rapid pace following the pandemic's onset in March 2020, mostly on the back of uninsured deposits. This growth of uninsured deposits was the result of Federal Reserve (Fed)'s unprecedented balance-sheet expansion (quantitative easing or QE), and in part, also of fiscal stimulus, though the latter raised insured deposits more than uninsured ones. As the figure below shows, quarters in which the Fed undertook greater QE and commercial bank balance-sheets expanded with reserves, so did their uninsured deposits. This is a typical, but underappreciated, feature of QE – it grows not only the size of central bank's balance-sheet, but also that of commercial banks, since non-banks tender their government securities to the central bank and get credited in their deposit accounts at banks.

Second, being passive recipients of such a large influx of uninsured deposits – on average at over $300 billion per quarter in the aggregate during Q1 2020 to Q1 2022 – many banks in the US sought carry over the near-zero cost of deposits by earning the term premium over the interest-rate yield curve in government and mortgage-backed securities. Even though term premia were compressed, the ease with which balance-sheets could be grown on the back of QE-infused deposits made banks lazy in their business models. Some of the banks that eventually failed also adopted highly concentrated asset and liability composition, taking the path of least resistance in business expansion by focusing on borrowers within a particular sector such as technology, crypto or commercial real estate, and even linked their deposit base entirely to the same sectors.

Lazy banking of this type that took hold in the US during 2020-2022 – fast growth on back of uninsured deposits, large investments in long-duration fixed-income securities, and concentrated sectoral exposures to borrowers and depositors – came to a screeching halt in March 2023 with the failures of

Silvergate, SVB and Signature banks within a single week. Uninsured depositors, warned by disclosures of losses on banks' securities portfolios and failed capital raise, fled the potentially insolvent banks for safer havens, in the form of money market funds and better-capitalized banks.

Lazy banking had, however, displayed signs of early stress starting in Q2 of 2022 itself, when Fed had to signal definite intent to start raising rates sharply in response to stubbornly high inflation. Banks started losing uninsured deposits then – in a "slow run" – to higher-yielding money market fund accounts. Rather than rein in risks and take remedial interest-rate hedging or capital-raising actions in a timely manner during this early phase of the tightening cycle in 2022, lazy banks doubled down on duration of fixed-income securities, unwound interest-rate swap hedges, and postponed capital-raising to the day of reckoning. It has now come to light that many of them opted into exceptions to switch their available-for-sale securities to hold-to-maturity portfolios and delayed the inevitable erosion of capital from becoming publicly well-known.

It would be a mistake, however, to conclude that risks from lazy banking are limited to further interest rate hikes. Several sectors of the US economy face headwinds at the present, most notably the commercial real estate sector. Some of this was underway even pre-pandemic and the pandemic simply accelerated the movement of footfalls away from shopping malls towards e-commerce. The pandemic has, however, shaken up the office real estate utilization due to the shift to work-from-home habits and the effective use of video-conferencing facilities. Some of the commercial real estate requires structural remodeling to be refashioned into residential units. Private equity firms and real estate developers undertaking such transformation would be taking on significant business risks and require that they acquire commercial real estate at steep discounts to find it profitable to do so.

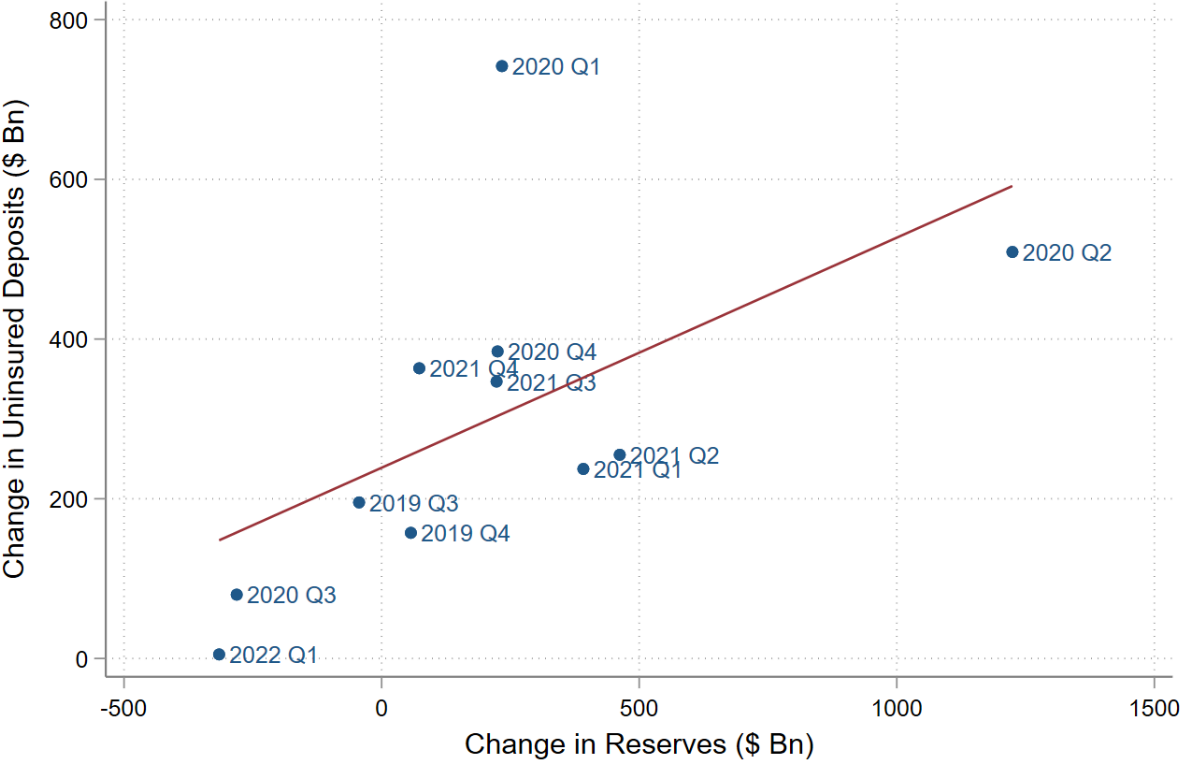
The bottom line is that there are likely to be mounting losses on commercial real estate portfolios of banks, especially regional banks, in the next year or two. Furthermore, some of this exposure sits with mortgage real estate investment trusts (m-REITs) that have increased their financing in the form of wholesale (repo) financing; as their rollover risk rises, they may draw down on bank lines of credit, transferring non-bank financial institution stress to the banking system. If banking system remains weakly capitalized to deal with these direct and indirect effects of commercial real estate slowdown, then it seems entirely within the realm of reasonable possibility to witness a repeat of the past episodes of extend-and-pretend evergreening or gambling-for-resurrection as was witnessed during the Savings and Loans Crisis in the US of 1980's, Japanese "lost decade" of 1990's and the Eurozone sovereign banking crisis of 2010's.

Having already contended with several bank failures, with defaulted liability base already larger than in past financial crises, it would be prudent for the US regulatory authorities to bite the bullet and undertake a comprehensive asset quality review of the commercial bank balance-sheets. A possible approach would be to conduct a *stagflation stress test*, in which the stress scenario features not only a recession leading to credit losses but also high interest rates leading to securities losses.

Bank capital would have to be ruthlessly marked to market, leaving aside the accounting tricks of hold-to-maturity portfolios. Some concession could possibly be given to banks up to their truly stable insured deposit bases. Undercapitalized banks, as per the stressed capital ratios, would need to raise public capital or be resolved via mergers, in some cases with regulatory assistance. Entirely decapitalized banks may require government capital injections by the Treasury, as was done with the TARP after the failure of Lehman Brothers.

In summary, even as some calm has been restored to the US banking with implicit but blanket cover being offered to uninsured depositors, the risks from lazy banking have shifted from contagious bank runs and disintermediation to that of undercapitalized banks engaging in a credit crunch to healthier parts of the economy while continuing to feed the distressed sectors. While runs can be salient and precipitate prompt, even overnight, regulatory responses, the slow economic sclerosis brought about by zombie lending can perpetrate and be left unattended for years.

The most robust and durable remedy against this impending risk of zombie lending by lazy banks is to raise their capitalization. Bank capital is a form of private deposit insurance and if it is marked earnestly, stressed plausibly, and raised adequately, it can prevent the banking stress of 2023 from morphing into a prolonged stagflation. Such regulatory action would also restore hope of bringing banks back to a state where not just their profits but also their losses are privatized.



Quarterly change in US commercial bank uninsured deposits versus Quarterly change in US commercial bank reserves (Source: FRED)