16 MAY 2023 Jennifer Grybowski

Regional banking concerns trigger financial services ETF outflows

SPDR's KRE sees a rollercoaster of flows

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Lipper financial services ETFs recorded their largest weekly outflow of the year over the past fund flows week (-$1.4bn), their highest outflow total since September 2022 and the 26th largest on record.

Financial services ETFs posted their worst annual net flow during 2022 (-$14.5) and were slowly clawing back at that total until the last two weeks of outflows.

This past week there has been a renewed worry over the regional banking world. On top of the bank failures, market participants are worried about the largest US banks gaining an increasing market share by allowing them to take over the smaller regional institutions.

Solutions that have been discussed have been increasing the FDIC's power to secure higher limits on a "targeted basis" and ban the ability to short sell bank stocks—something JPMorgan CEO Jamie Dimon has backed.

Raising the FDIC insurance limit still has its risks; by guaranteeing more money in deposit accounts, the banks' incentive to invest in riskier long-term assets only increases—which is how we got here in the first place.

The latter argument of banning the short selling of bank stocks may help limit the downward pricing pressure on the stocks, but this artificial market maneuver would more than likely only be a temporary solution.

In 2008 the SEC announced a formal ban on short sales of roughly 800 financial stocks. The ban had the intention to decrease market volatility as well as to "protect the integrity and quality of the securities market and strengthen investor confidence."

The week after this announcement in 2008, the Lipper financial services ETFs classification attracted its second-largest weekly inflow (+$4bn) and returned a positive 9.8% over that week, its 13th highest weekly return of all time. Immediately, just the announcement of the removal of selling short attracted significant capital.

The following two weeks saw outflows, followed by the second-worst weekly return on record (-24.7%).

A study released in 2012 by the Federal Reserve Bank of New York on the effects of the '08 short sale ban said: "If anything, the bans seem to have the unwanted effects of raising trading costs, lowering market liquidity, and preventing short sellers from rooting out cases of fraud and earnings manipulation. Thus, while short sellers may bear bad news about companies' prospects, they do not appear to be driving price declines in markets."

Any fix or regulation on the regional banking system needs to be more thought out and structured to attract the root causes of the crisis as opposed to simply trying to limit the downward pressure of share prices.

Looking at the daily flows for the SPDR S&P Regional Banking ETF (KRE), the ETF had strong inflows last Monday, but has suffered four straight daily outflows since then.