Quick Take

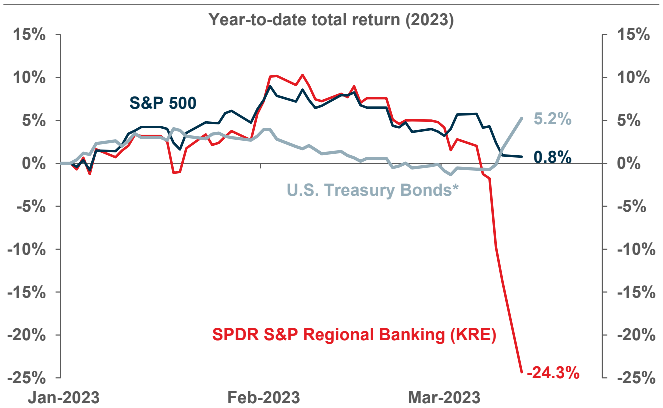
CIO Office | March 13, 2023

U.S. regional banks in turmoil

Over the past few days, market angst has increased significantly as the rapid collapse of Silicon Valley Bank (SVB) –the 16th largest U.S. bank by assets until recently – and financial distress in the entire regional banking sector have investors fearing the worst.

For now, the negative impact is mostly confined within the sector of concern, with its benchmark index losing 23.4% since last Tuesday (-24.3% YTD), compared to a 3.2% decline for the S&P 500 (+0.8% YTD) and a 6.0% gain for U.S. Treasuries (+5.2% YTD) (**Chart 1**). Nonetheless, an update on the situation is in order.

1 | "Small" banks, big problems



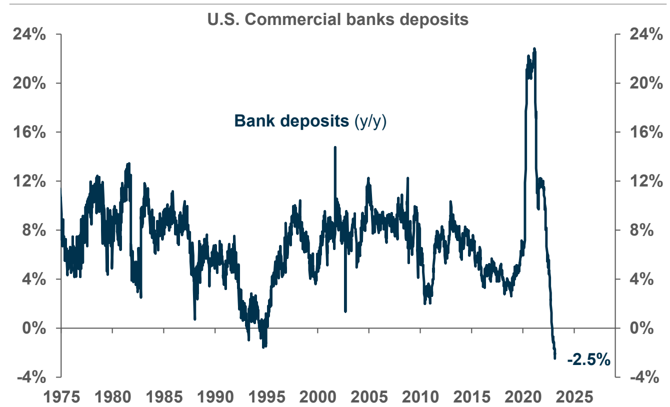
CIO Office (data via Refinitiv). *ICE BofA 7-10yr US Treasury Index.

What's going on?

In its most simplified form, a bank's activities traditionally boil down to taking deposits (a short-term liability for the bank) and making loans (a long-term asset). To ensure its sustainability, the financial institution must therefore ensure that it maintains sufficient high-quality liquid assets to meet bank withdrawal demands at all time.

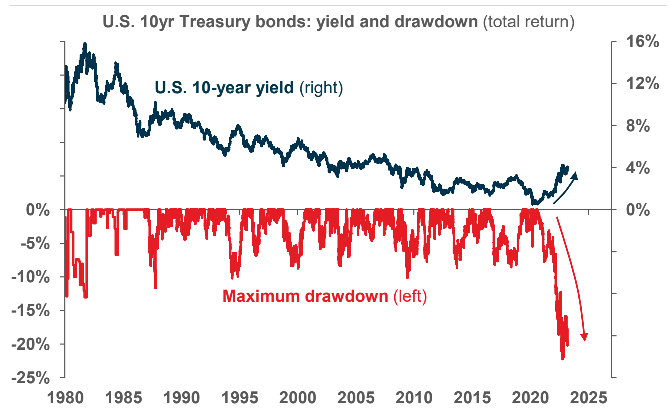
Now, the peculiarity of the current environment is the speed and magnitude with which the Federal Reserve has raised interest rates over the past year, with two important consequences for banks. First, it has put downward pressure on bank deposits as alternative investments with attractive risk-free returns now exist (as evidenced by the slowest annual growth in U.S. bank deposits since records began, **Chart 2**). Second, as with all investors, the market value of bonds held by banks has declined significantly since the start of the rate hike cycle (**Chart 3**).

2 | Bank deposits are facing headwinds…



CIO Office (data via Refinitiv).

3 | … following an unprecedented drop for bonds



CIO Office (data via Refinitiv).

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In and of itself, downward pressure on bank deposits together with a drop in the value of bonds held to ensure the ability to pay withdrawals is certainly a challenge for any financial institution. However, it is not necessarily problematic, provided that (1) the profile of depositors is relatively diversified and (2) the duration of the assets held by the bank has a similar profile to its liabilities, allowing it to ride out fluctuations in the market value of bonds until it recovers its capital at maturity.

In SVB's case, (1) the significant concentration of its clients within the technology sector – flush with cash in 2020-2021... much less so now – as well as (2) a balance sheet significantly overexposed to long-term bonds quickly became problematic. Faced with a mismatch between its assets and liabilities, SVB attempted to raise new capital in early March, which instead highlighted the fragility of its financial position, causing its depositors to run to the "cash out" button and its shareholders to the "sell" button.

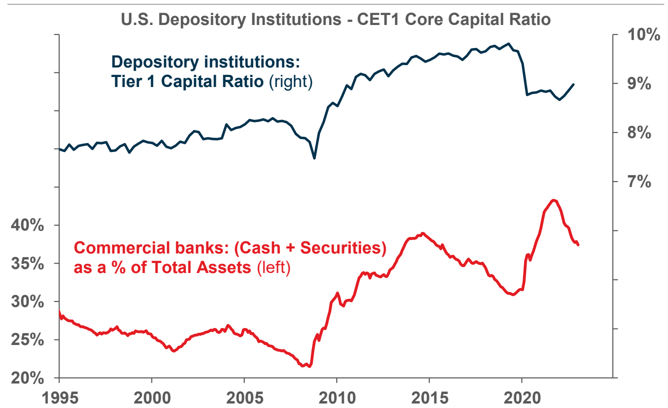
This is not a financial crisis...

This classic "bank run" is reminiscent of a certain September 2008. However, 15 years later, the situation differs in several fundamental ways, including two in particular.

First, the speed at which government agencies intervened. By Friday, just three days since SVB's demise, the Federal Deposit Insurance Corporation (FDIC) took control of the bank. By Sunday evening, the Fed, the FDIC and the U.S. Treasury announced that all (above the usual 250k) bank deposits would be covered. In addition, the Fed set up a loan facility that allows other potential troubled banks to borrow against the face value (par) of the bonds they hold rather than being forced to sell them at heavy losses in the markets. In short, while the monetary and fiscal authorities' belated response in 2008-09 ensured that they would face more than a decade of criticism, they could hardly have stepped in more quickly this time.

Second: the better capitalization of the banking sector. Overall, today's banking regulations impose a much more conservative balance sheet management, as illustrated by the upward trend in the CET1 capital ratio and in cash and securities as a percentage of total assets (**Chart 4**). Clearly, there are exceptions, but fortunately, we no longer face the same systemic risk as in 2008-09.

4 | Banks are significantly better capitalized



CIO Office (data via Refinitiv, FDIC & FRED).

… but it's not inconsequential

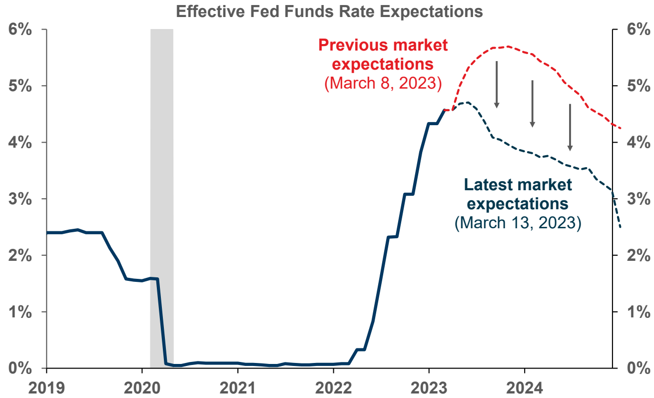
On the micro level, we should probably expect more restrictive regulation for U.S. regional banks – they often fall outside of stricter Basel III liquidity standards[1] – while additional closures and/or consolidations cannot be ruled out.

That said, for now, it is probably on the macro front that the consequences are most significant, with markets now expecting only one rate hike this year, compared to a minimum of four hikes barely a week ago (**Chart 5**, next page).

To put things in perspective, this change in expectations took 2-year yields 109 bps lower in just three days, a move that is comparable only to the infamous October 1987 (**Chart 6**, next page).

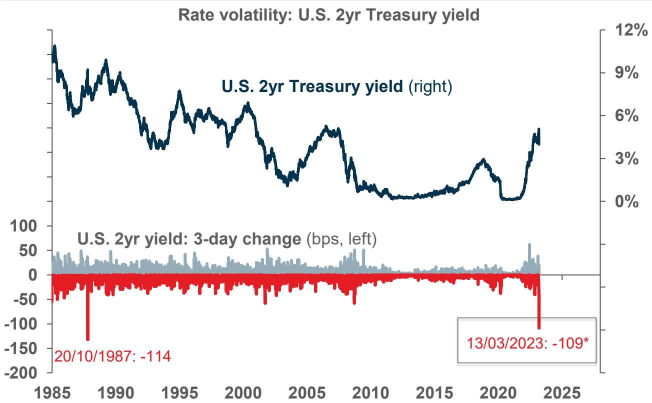
[1] Silicon Valley Bank is a very American mess, Financial Times, March 10, 2023

5 | Rate hike expectations fall...



CIO Office (data via Refinitiv). As of March 13, 16:15.

6 | ... at an almost unprecedented speed



CIO Office (data via Refinitiv). *As of March 13, 4:00PM.

Every tightening cycle comes with its set of surprises, and the recent distress of U.S. regional banks is a prime example. One thing is certain, the Fed's balancing act is getting more complicated as the central bank seeks to harmonize inflation with employment while ensuring financial stability. A tall order.

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General

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