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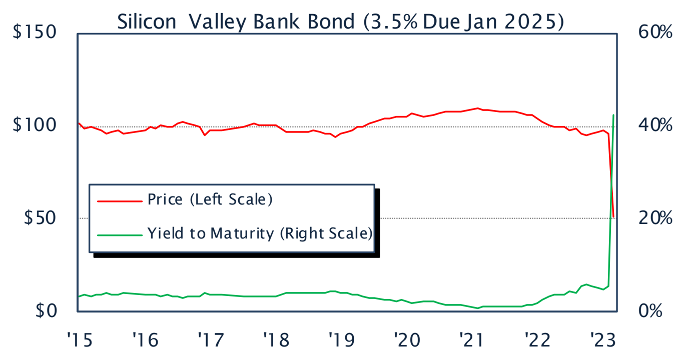
INVESTMENT UPDATE

By now you've no doubt heard about the two large US regional banks that were shut down by regulators earlier this month, after both were unable to meet the demands of their depositors. Bank liquidations aren't unusual (there have been something like 550 US bank failures in the past 20 years) but the two banks in question— California's Silicon Valley Bank (SIVB) and New York-based Signature Bank (SBNY)—were the second- and third-largest banking institutions to be shut down in US history.

As we pick through the stories coming from regulators and industry insiders, it's clear that they both failed for a variety of reasons—some specific to these two banks, and other factors that all banks are currently grappling with. Although there will be more information forthcoming, we feel pretty confident that better risk controls and more capable management could have saved these two institutions, and that the US banking system itself remains sufficiently regulated and capitalized, and is in no particular danger of a 2008-style liquidity crisis.



To quickly recap the specific issues that took these institutions down, it's important to identify what made them different from your average, smaller "regional" bank. First, neither bank served the typical retail bank customer, nor was either involved with the kind of banking activities of a typical smaller bank. Both served niche markets—in the case of SIVB, its customers were tilted towards the tech industry, including many of the movers and shakers in the West Coast private equity business. It didn't pursue typical retail clients in the 17 branch offices in the cities and towns it was located in, and neither did Signature Bank out of its 40 branch offices.

The depositors of these niche banks were not households and small businesses, they were mostly high net-worth clients and other "hot money" deposits. This type of customer has no particular loyalty or affiliation with the institution, and is far more likely to pull their deposits and take their money where they can get the best rate of return. Traditional retail client deposits are much stickier, and not as sensitive to interest rates—after all, it's a pain in the neck to switch your checking account. On the asset side of the ledger, these niche banks likewise didn't make small loans to local businesses in the same way as a traditional small or regional bank, instead holding a larger share of investment securities than loans as assets.

Both banks saw a big boost from the rise of cryptocurrencies over the past couple of years, both on the asset side (SIVB had become a major lender to crypto-related ventures) and on the deposit side (SBNY was one of the first US banks to accept cryptocurrency deposits). The collapse in the crypto markets over recent months helped to put both institutions on the path to failure. For SIVB, that meant having to set aside significant reserves against possible loan losses; for SBNY, customer deposits withered along with the prices of crypto shares.

As we now know, the demise of these institutions was swift. Hot money depositors with large balances wasted no time in pulling deposits from these banks, fearing that the FDIC's deposit insurance would not provide full protection in the case of failure. In order to meet the demands of customers, the banks were forced to sell assets, as they had insufficient cash on hand. But the assets of both banks were worth far less than their book value (banks typically place investment holdings and loans into the "hold to maturity" category), which meant marking those assets down to current market values for the first time, which in turn evaporated the institutions' shareholders' equity. SIVB attempted an emergency re-capitalization plan to replenish the lost funds, but those plans were quickly scuttled. SBNY never got a chance to try to raise funds, as regulators shut the bank down in order to protect depositors.

Importantly, the US Treasury announced that it would cover all depositors—even those with balances above $250,000 (the statutory limit)—but would not protect shareholders or bondholders of either institution. The Fed also stepped up and announced a temporary broadening of its discount window policies, allowing any member bank to borrow against the full par value (not the discounted market value) of any eligible security the bank holds, in order to bolster the confidence of both depositors and bank management.

The failure of these two banks shook the confidence of the capital markets, and (at least) briefly caused a general flight to quality, sending stock prices lower—especially those of small and regional banks—and bond prices higher. As the chart on the first page shows, SIVB's outstanding bonds (we show its 3.5% bonds maturing in 2025) displayed no particular signs of stress until very recently, when the price of its debt fell from $96 to $51, with a corresponding spike in the bond's yield). In Europe, the Swiss central bank was forced to arrange a takeover of Credit Suisse by UBS (Union Bank of Switzerland), as the former bank's multi-year struggle to recapitalize came into sharper focus. Despite this turmoil, as the dust settled, most investors seemed satisfied that the weaknesses of these institutions were fairly isolated, and that policymakers took timely action to restore confidence in the global banking system.

But we're not completely out of the woods. As mentioned above, there are macro issues that weakened not just SIVB and SBNY, but are impacting the larger banking industry. In simple terms, what changed was the end of "free money." Even prior to the impact of COVID in 2020, policymakers had pursued highly accommodative monetary and fiscal policies designed to stimulate the US economy in the decade-plus period following the 2008 financial crisis. While the memories of that period may now be hazy, it's worth remembering that the Fed kept its overnight fund rate pegged at zero from 2008 to 2015; the Fed funds rate didn't rise above 1% until 2017. Meanwhile, in order to keep longer rates down, the Fed implemented large-scale bond purchase programs which pulled trillions of dollars of US government bonds out of circulation, and returned cash to the holders of those bonds. Of course, when COVID hit, the Fed funds rate was cut back to zero and even more money flooded into the economy.

Banks earn money primarily by deploying depositors' funds to make loans and invest the rest (typically in bonds), earning the yield spread between what it makes on its loans and investments and what it pays to depositors. Over most of the past 15 years, banks had an extremely friendly backdrop to work in; the cost of doing business (paying interest on deposits) was essentially subsidized by policymakers down to zero, allowing banks to pocket most of what they were making on their loans and investments. This was partly by design, as the US banking system needed to be recapitalized after the financial crisis, and was expected to provide credit to businesses and households while COVID was ravaging the US population in 2020 and 2021.

Deposit growth soared during the COVID period, but loan growth did not keep up as households and businesses had (in aggregate) plenty of cash and equivalents. Facing a lack of loan demand, banks grew their investment portfolios, mostly with short- and intermediate-maturity US government bonds. With these high quality assets, banks could also more easily meet the post-financial crisis capital requirements than they could with the same dollar amount in their loan portfolio. Very short maturity Treasury and agency bonds didn't offer a lot of yield, so there was a strong incentive to buy longer, higher yielding maturities to boost the interest rate spread the banks were making.

It's also worth noting that regional US banks asked to be relieved of some of the capital requirements that were imposed on banks after the 2008 financial crisis. In fact, in 2015, SIVB's then-CEO Greg Becker, in a statement to members of a Senate bank committee, argued that the toughest capital standards should be applied only to banks with assets above $250 billion, well above the $50 billion break-point at the time. While some will retroactively stifle a chuckle at Becker's statement that "SVB, like our mid-sized bank peers, does not present systemic risks" to the banking system, we would hasten to point out that the regulations were relaxed the very next year in an overwhelmingly bipartisan fashion.

In any case, by the end of 2021 it was clear that the ultra-friendly backdrop for banks would be coming under pressure. Inflation was accelerating in a way that the Fed could no longer claim was "transitory." Bond prices, especially for longer maturities, were falling as investors demanded higher yields to compensate for higher inflation. The Fed announced that both the asset purchase program and zero percent overnight rates would be ending. Yet, loan growth picked up in late 2021 and throughout 2022, with the Fed's surveys showing commercial and industrial loans growing at a sustained pace throughout 2022 at a rate faster than any other post-financial crisis year. The changes to the yield curve throughout 2022 were dramatic, and the losses experienced by investors were historic, with the broad-based Bloomberg Aggregate Bond Index losing more than 13% of its value last year.

As we alluded to above, while most bank loans and investments are typically valued at book value, those assets lost value at an alarming pace along with every other interest-rate sensitive security over recent months. The financial statements can only partly hide what has been happening to the value of banks' assets. At the same time, banks are now having to pay higher rates on deposits as interest rates soared over the past year, further pressuring profit margins.

The result is a banking system that is carrying big losses in its collective investment portfolios. Strong, well-managed banks have plenty of capital and good balance sheet management; they can withstand (and in some cases, profit from) the macro pressures that exist in this environment. With time, banks' high quality bond holdings will mature at par value, and the unrealized losses will fade. But in the meantime, margins are getting squeezed, profits are thin, and investors are worried.

The US economy has shown a great deal of strength in the face of the Fed's tightening policies up until now. But the cracks in the growth story are starting to show.