From the Desk of Mitch Zacks: An Update on the U.S. Banking System

Many readers are likely aware of two high-profile bank failures in recent days, Silicon Valley Bank (SVB) and Signature Bank (SBNY). Most bank failures historically have been caused by credit risk issues, but SVB and SBNY were unique cases where a run-on deposits needed to be offset by selling long duration securities at significant losses. It wasn't long before word got out that SVB had a massive portfolio of long duration securities in the red (marked to market), which altered the bank's capital profile almost overnight. Capital ratios at both banks plummeted, moving regulators to shut down the banks citing inadequate liquidity and insolvency.[1]

To help readers better understand how this happened, I'll go into greater detail about the downfall of SVB.

2020 and 2021 were historic years in terms of a massive surge in liquidity coming from fiscal and monetary stimulus, and much of this new liquidity showed up in explosive growth in deposits, with venture capital money notably pouring into early-stage companies in 2020 and 2021. SVB happened to be a bank that catered mostly to early-stage technology companies, venture capital companies, and private equity firms. According to the company's website, about half of the U.S. tech and healthcare firms that IPO'd last year were SVB customers.

It follows that in the year following the Covid-19 lockdowns, SVB saw its deposits surge from $62 billion to $124 billion, a roughly 100% increase at a time when most banks were experiencing 20% to 30% increases in deposits. Of course, SVB was not alone is seeing deposits surge – between Q4 2019 and Q1 2022, deposits at U.S. banks went up by $5.4 trillion. But it was an outlier in terms of how substantially and quickly its deposit base grew.

The problem with SVB was that its massive deposit growth came at a time when the fed funds rate was anchored to the zero bound, and U.S. Treasuries were paying 2% at most, but often far less. The bank heavily invested new deposits in long duration Treasuries and other types of fixed income, which while normally a prudent action, turned out to be a matter of terrible timing. As the Fed encountered surging inflation and responded with rapid interest rate increases, yields across fixed income durations moved higher, deeming the fair market value of much of SVB's securities portfolio as far lower than its balance sheet value.

In short, SVB was facing major issues in both its assets and liabilities:

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[1] J.P. Morgan

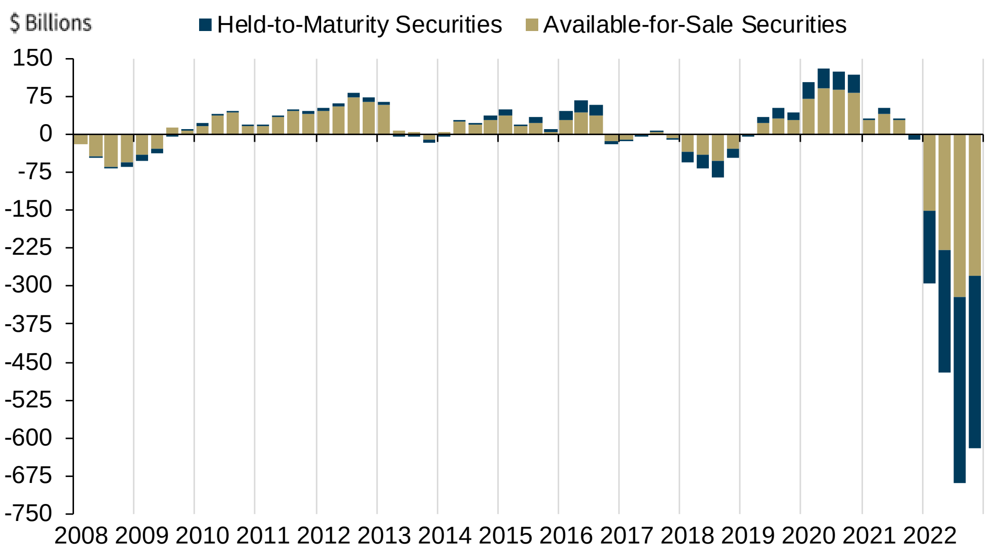
- Asset problem: buying bonds at generational lows in yields, which turned into sizable unrealized losses as interest rates moved quickly higher.
- Liability problem: undiversified deposit base that relied heavily on institutional and venture capital funding, versus traditional retail deposits. As big clients started to leave, everyone followed.

The reason the run-on deposits happened so quickly for SVB is that most of its clients were exposed to losses: out of SVB's $173 billion of customer deposits at the end of 2022, $152 billion were reportedly uninsured – that's 93%!

The bottom line is that SVB carved-out a very distinct, lucrative niche in the VC and tech world, but that also set it up for large capital shortfalls in case of rising interest rates, deposit outflows, and forced asset sales – all of which happened.

I want to be clear here that SVB was very much in a league of its own when it comes to percent of deposits that were uninsured, and also in the ratio of its long duration debt securities to total assets, which at 40% was extremely high. As seen on the chart below, many banks are underwater on their fixed income portfolios, but none (as far as we can see) have the level of duration risk that SVB had.

Unrealized Gains (Losses) on Investment Securities



Source: FDIC.
Note: Insured Call Report filers only.

Investors may look at the chart[2] above and think all banks are in big trouble, but that is not really the case. When the Fed stress tests systemically important banks, all unrealized losses in available-for-sale securities are required to be reflected in capital ratios. Held-to-maturity losses are not included in capital ratios, but assuming there is not a run-on deposits, a bank is not likely to have a need to sell those securities at losses to shore up capital. No large banks are experiencing deposit flight, and in fact the opposite has largely been true over the past few days.

Regional banks are a different story. When calculating capital ratios, regional banks are not required to adjust for held-to-maturity or available-for-sale losses, which is why many are currently under a great deal of pressure from investors. The question that many investors and depositors are asking about regional banks is: what duration risk did each bank take in its securities portfolio during the deposit surge of 2020 and 2021, and how much of that was invested in debt securities with generationally low yields? These are the questions circulating banks like First Republic, Comerica, Western Alliance, and others. Whether or not these banks can cling to deposits and avoid fear-induced flight may ultimately be the key to survival.

Credit Suisse also made headlines this week as the potential next shoe to drop, but unlike SVB, Credit Suisse does not have large amounts of held-to-maturity assets. The bank however has been seeing deposit outflows, and some local units breached regulatory liquidity coverage ratios recently, meaning there was not sufficient liquidity in their securities portfolio relative to deposits. The Swiss National Bank has stepped in to offer a lifeline should Credit Suisse need it, while indicating the bank overall has sufficient capital available.[3]

Here in the U.S., the Federal Reserve and regulators sought to calm the markets by pledging to make SVB depositors whole, including all those with deposits over the FDIC-insured $250,000 limit. The Fed was hoping this action would also stem the flight of deposits from other regional banks like the ones listed above.

The Fed went a step further to protect regional banks from insolvency by creating a special emergency facility where debt securities like long duration U.S. Treasuries could be used as collateral for loans, giving banks access to liquidity without having to sell securities at a loss. This emergency capital can prevent a bank from becoming insolvent, but the issue of owning debt securities with fair market value below balance sheet value remains – as long as interest rates are elevated relative to where they were in 2020 and 2021.

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[2] FDIC, https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2022dec/
[3] The Wall Street Journal, https://www.wsj.com/articles/credit-suisse-shares-plunge-as-bank-storm-spreads-to-europe-7251349d

Which brings us to perhaps the biggest question facing the markets today: *what does the Fed do with monetary policy from here?*

The Fed is still confronting too-high inflation, with core CPI (excludes food and energy) rising by 5.5% from February 2022 to February 2023, its smallest 12-month increase since December 2021. That's still well above the Fed's 2% target, but continuing to raise the benchmark fed funds rate would risk creating even more losses on bank balance sheets, which in turn raises the risk of financial contagion. On the other hand, pausing or even cutting rates risks abandoning the inflation fight, which is clearly not yet won. My guess is that the Fed will be thinking hard about a 'pause,' which could arguably be construed as bullish for the broader equity markets and bond prices.

Bottom Line for Investors

The past few days have reinforced the importance of risk control in portfolios, not just for banks, but for all investors. Risk control is an important part of our investment process at Zacks Investment Management, and our diversified equity strategies are all designed to mitigate risk in addition to generating excess return. Exposures to industries (relative to the benchmark) are constrained in all strategies, so the impact of the past few days has had limited effect.

Our systematic and disciplined investment process will continue to seek opportunities in mispriced stocks, including regional banks, but the process will also look to control risk relative to each strategy benchmark. Risk control will look to limit any significant bet in individual positions or any overexposure to any industry, such as regional banks. Alpha factors such as estimate revision, standard deviation of earnings estimates, recent earnings estimates vs. consensus, and short interest to shares outstanding, should all respond quickly to any underlying risks or opportunities of each position in the portfolio.

All strategies are monitored in real time and each portfolio manager has the authority to override the models and the process, particularly if there are significant risks that may not be captured by models estimated over periods that do not reflect the current environment. Portfolio manager judgement, particularly with respect to risk control, is a critical component of our investment process, especially in times like these.

We are closely monitoring the situation and will keep you updated if conditions change. As always, if you have any questions or concerns whatsoever, please reach out to your Zacks representative.

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