March 14, 2023

Impact of Recent Bank Failures

Introduction

The closure of Silicon Valley Bank (SIVB) on Friday and Signature Bank (SBNY) over the weekend has rattled markets and created concern for investors. SIVB was the second biggest bank failure in history and the largest since the Great Financial Crisis. On Sunday evening, U.S. regulators announced that all deposits, FDIC insured or not, held in SIVB & SBNY accounts would be guaranteed.

This situation and the government response remain very fluid at this point in time. Further fallout and contagion from these bank failures depend heavily on the policy response and may also affect the banking sector and potentially the expected path of future rate hikes.

In this note, we address frequently asked questions regarding these recent developments, what policy makers announced over the weekend, the health of the U.S. banking sector, and risks of further contagion in markets.

What caused the rapid collapse of Silicon Valley Bank (SIVB)?

- SIVB had been growing its deposit base rapidly over the last three years and used those deposits to purchase fixed income securities designed to hold to maturity[1]
- Rising rates through 2022 led to significant unrealized losses on SVB's fixed income portfolio[2]
- The low yields that banks were paying on deposits relative to 3-month Treasury yields led to an exodus of banking deposits
- SIVB was required to sell a portion of their fixed income portfolio at a loss to fund deposit outflows
- This announcement led to a "run on the bank" as other depositors wanted to ensure they would have access to their funds
- To make matters worse, SIVB had the second highest ratio of uninsured deposits of any FDIC eligible bank[2]

Why did regulators also take over Signature Bank (SBNY)?

- Following SIVB's takeover, concerns quickly shifted to SBNY given some similar characteristics in their financial condition
- Similar to SIVB, SBNY's deposit base was also highly concentrated
- But SBNY had a higher percentage of their deposits that were uninsured compared with SIVB[3]

What has been the policy response from the government?

- The U.S. Treasury, Federal Reserve, and FDIC issued a joint statement on Sunday March 12th
- The FDIC was given the authority to fully protect all depositors of SIVB and SBNY, including those previously uninsured with balances over $250,000[4]
- The Federal Reserve announced that it will make available additional funding to eligible depository institutions to help assure they are able to meet the needs of all their depositors[4]
- We believe the swift nature of this response shows that the political will for depositor loss is extremely low
- If necessary, the government may consider insuring all deposits throughout the banking system, as it did before during the Great Financial Crisis

What impact will these initiatives have on the banking sector?

- The policy measures taken thus far are significant and aimed at protecting depositors and preventing contagion to other banks as much as possible
- We believe the banking system is stronger and better capitalized today than it was going into the Great Financial Crisis
- In our view, the actions taken thus far by policymakers, combined with the idiosyncratic nature of SIVB's business risks, lowers the likelihood of broad contagion in the banking sector, however it is difficult to predict; We believe policymakers would likely enhance their response should signs emerge of the panic spreading

How will this impact the broader equity market?

- The U.S. equity market is holding up well thus far, despite the regional banking sector taking a hit; Month to date through 3/13/23, SPDR S&P Regional Banking Index (KRE) is down around 28%
- The announcement by policymakers over the weekend sets the precedent for the foreseeable future: depositors' losses are not going to be tolerated while equity holder losses should be expected if the situation intensifies
- We expect there could be ripples flowing out of this event more broadly into risk assets; But broad equity markets reacted slightly positively to the policy responses announced on Sunday evening, showing signs that the broad market was preparing to weather the storm

Are there ancillary impacts for private market investments?

- Many private equity and venture capital firms, and their portfolio companies, had banking relationships with SIVB
- Some of those firms moved proactively to shift their cash balances to other banks, while others will await the support from the FDIC
- In the meantime, risk-taking in general may be restrained in the private market sectors

What about in the fixed income markets?

- Yields have declined in the wake of the SIVB failure; The 10-year U.S. Treasury yield declined to 3.55% on Monday, down from 3.97% the week before
- Corporate credit spreads have increased in response to recent events, particularly spreads for lower quality bonds
- Liquidity in the Treasury markets remains with historically normal ranges

What does this mean for Federal Reserve policy from here?

- Market expectations for the Federal Funds rate have been aggressively trimmed in light of this ongoing stress in the banking system
- Last week, the expectation for further Fed increases this year was between 100 and 125 basis points; Currently, most of the increases have been priced out and cuts later in 2023 and 2024 are being priced into expectations[5]
- In our view, economic data such as inflation and employment will continue to be key drivers of monetary policy going forward
- The outcome of the next Federal Reserve policy meeting will be closely watched for signals about their intentions to continue increasing interest rates

Conclusion

- We believe it is important to not get caught up in the news and headlines around crisis events
- Market volatility can create anxiety in the short-term but may also present longer-term opportunities
- Sticking to long-term plans during times of stress is often the best decision
- We continue to monitor developments closely for both additional risks and potential opportunities, which may include increasing allocations to bank stocks when financial conditions stabilize

[1] https://www.wsj.com/articles/bond-losses-push-silicon-valley-bank-parent-to-raise-capital-125e89d4
[2] SpringTide Market Note: Silicon Valley Bank Q&A; 3/13/23
[3] Raymond James & Associates; S&P Global; 3/12/23
[4]Treasury, Federal Reserve, and FDIC Joint Announcement;
https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm
[5] J.P. Morgan Asset Management conference call 3/13/23

The SPDR® S&P® Regional Banking ETF (KRE) seeks to provide investment results that, before fees and expenses, correspond generally to the total return performance of the S&P® Regional Banks Select Industry Index, which comprises stocks in the S&P Total Market Index that are classified in the GICS asset management & custody banks, diversified banks, regional banks, other diversified financial services and thrifts & mortgage finance sub-industries.

All market pricing and performance data from FactSet, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

The opinions and analyses expressed in this newsletter are based on RMB Capital Management, LLC's ("RMB Capital") research and professional experience are expressed as of the date of our mailing of this newsletter. Certain information expressed represents an assessment at a specific point in time and is not intended to be a forecast or guarantee of future results, nor is it intended to speak to any future time periods. RMB Capital makes no warranty or representation, express or implied, nor does RMB Capital accept any liability, with respect to the information and data set forth herein, and RMB Capital specifically disclaims any duty to update any of the information and data contained in this newsletter. The information and data in this newsletter does not constitute legal, tax, accounting, investment or other professional advice. Returns are presented net of fees. An investment cannot be made directly in an index. The index data assumes reinvestment of all income and does not bear fees, taxes, or transaction costs. The investment strategy and types of securities held by the comparison index may be substantially different from the investment strategy and types of securities held by your account. RMB Asset Management is a division of RMB Capital Management.