Regional Bank Implications from Silicon Valley Bank Fallout

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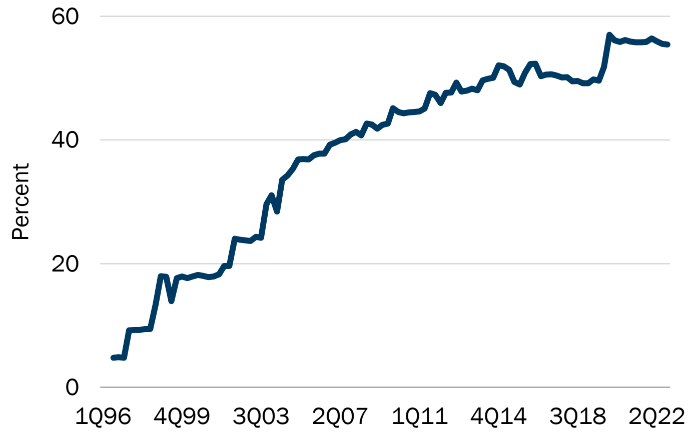
Regional Banks Are the Backbone of the US Economy

US regional and community banks total over 4,600 in number. The eight largest US banks collectively hold 63% of the banking industry's total assets ($23 trillion), meaning regional and community banks hold a large share of the country's banking assets. Non-G-SIB banks (globally systematically important banks) are important providers of credit to middle market corporations as well as consumers. Small businesses of 500 employees or fewer make up 99.9% of all U.S. businesses and 99.7% of firms with paid employees.[1] Hence, the events of recent days are economically significant.

FIGURE 1: SHARE OF INDUSTRY BANKING ASSETS BELONGING TO BANKS WITH ASSETS OVER $250BN



Data as of December 31, 2022.
Source: FDIC

Regulators Looked to Bring Calm to the Bank Funding Market — We Believe This Should Work for Now

On Sunday evening of March 12, 2023, the Treasury, FDIC and Federal Reserve collectively announced two key policy measures to stabilize the US banking system following the failure of three banks earlier in the week. These measures sought to underpin the liquidity and capital of US regional and community banks. The measures included:

- The FDIC made all depositors whole in both Silicon Valley Bank (SVB) and Signature Bank (SB), including uninsured depositors. This is important as it helps allay fears of large losses to uninsured depositors. For example, last Friday only SVB's insured deposit accounts were covered by the FDIC deposit insurance fund. The Deposit Insurance Fund provides insurance for deposits up to $250,000. The risk of losses to uninsured deposits panicked firms (mostly in the technology sector which was disproportionately exposed) that had deposits with SVB. The full deposit insurance program ensures smaller firms that deposited with SVB and SB will not suffer losses. This was an important proactive measure as it helps prevent the failure of these banks creating economic shocks that could infiltrate into the wider economy.

  The FDIC has examined the potential effects on economic growth of a 5% run on uninsured deposits and found that in a stressed environment, GDP growth could be reduced by almost 2% per year.[2] In today's slowing economy, such an event could push the economy into a recession.

- Regulators also announced the Bank Term Funding Program (BTFP), which allows banks to borrow from the Federal Reserve against a broad range of collateral (US sovereign and agency backed collateral used in open market operations) for a one-year term at overnight index swap rates + 10bps. The BTFP allows banks to borrow at the par value of pledged securities; this addresses both liquidity and capital issues. For banks with assets less than $700bn (where, based on current regulations, changes in the value of bonds do not impact capital bases), this facility means these banks can obtain liquidity by pledging qualifying assets at 100% of par value, even if assets have a lower mark-to-market value. Thus, banks do not need to sell qualifying assets at values below face value; selling bonds below face value could create a realized loss and adversely impact bank capital ratios.

1. Source: FDIC, Bloomberg, SBA
2. Source: FDIC

Is This Enough?

We are unsure whether these measures are sufficient. The US deposit market totals approximately $18 trillion and of this, almost $8 trillion is uninsured.[3] Following recent developments, depositors are likely to assess the safety of their uninsured deposits and readjust their deposit exposures.

The BTFP facility will be funded with $25bn by the Treasury Exchange Stabilization Fund (ESF). This $25bn represents the credit protection offered by the Treasury to the Federal Reserve to protect against any losses incurred. The Federal Reserve did not announce how large the facility could grow, but indications are it could be levered up to 20 times. Moreover, the size will likely be a function of the balance sheets of the banks using the facility.

According to the FDIC, the US banking system had almost $6 trillion of securities at the end of Q4 2022 with unrealized losses $620bn. The ultimate size of the BTFP may need to reflect the size of the banking industry and the path of interest rates.

We note there is a broader impact from the facility: a growing facility may also have the effect of offsetting some of the Federal Reserve's QT it has already enacted (see Figure 2).

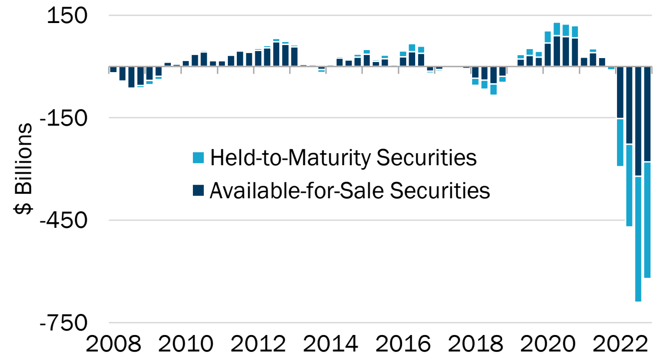
Money in Motion

The FDIC did not guarantee system wide deposits. Consequently, we expect large uninsured depositors to assess the financial strength of their banking counterparties. As such, we expect smaller regional and community banks may experience deposit outflows as larger uninsured depositors look to diversify their deposit banking relationships.

A silent bank run may be underway as depositors look to transfer money to larger banks that are perceived to be too-big-to-fail.

Ironically, allowing larger banks to grow larger may be exactly what the regulators are trying to prevent. In a recent speech, regulators pointed out that the "larger, more complex banks pose the greatest risk and impose greater costs on society when they fail"[4]. We point out that Wells Fargo is still prevented from growing its balance sheet beyond $2 trillion, so it may be able to attract sizable deposits.

FIGURE 2: UNREALIZED GAINS (LOSSES) ON INVESTMENT SECURITIES HELD BY BANKS



Insured Call Report filers only.
Source: FDIC

Banks may also learn from the recent experiences of some private equity property funds where these funds imposed gates on investors seeking to redeem their investments. It is plausible that banks may now create their own gates to limit large corporate depositor withdrawals. This could push large corporate depositors into very short-term money-market funds (a product being contemplated in the market which would offer a very short-term, instant access corporate cash money market account). Investors in such products should be aware that they may expose themselves to other sources of risk with such instruments. With mounting concerns over the debt ceiling and large T-Bill issuance expected in Q4 2023, issues could emerge for corporations that purchase such funds as alternatives to traditional deposit accounts should the front end of the yield curve become volatile.

Higher Funding Costs

Regional banks may now need to pay higher interest rates to attract and retain retail deposits while at the same time overhauling their assumptions on the stickiness of these deposits. All told, we expect regional bank profitability to be pressured by higher funding costs. Regulators are also expected to levy higher deposit insurance fund premiums on banks' insured deposits as the FDIC bolsters the size of its Deposit Insurance Fund. The Deposit Insurance Fund is used to pay out losses incurred by the FDIC when it takes over a bank and pays out deposits

3. Source: FDIC
4. Source: OCC, January 17, 2023

FIGURE 3: DOMESTIC DEPOSITS | $BN

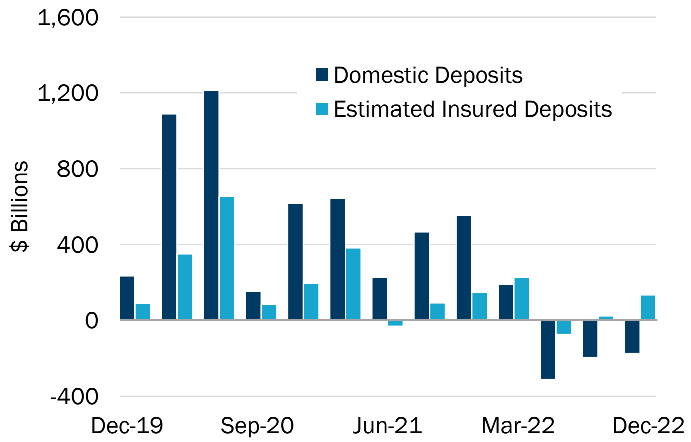
	2022		2012
JPMORGAN CHASE	2,128	BANK OF AMERICA	1,129
BANK OF AMERICA	1,988	WELLS FARGO	891
WELLS FARGO	1,465	JPMORGAN CHASE	865
CITIGROUP	764	CITIGROUP	396
U.S. BANCORP	455	CAPITAL ONE FIN	233
PNC FINANCIAL	447	U.S. BANCORP	221
CHARLES SCHWAB	442	PNC FINANCIAL SVCS	203
TRUIST FINANCIAL	435	TORONTO-DOMINION	170
CAPITAL ONE FINANCIAL	399	BB&T CORPORATION	132
TORONTO-DOMINION BANK	388	SUNTRUST BANKS	130

Source: FDIC

Banks will focus on trying to win corporations' operational deposits as banks perceive these deposits to be sticky. In fact, bank liquidity regulations encourage banks to focus on this deposit type. To attract corporations' operational deposits, banks will likely pay higher interest rates and/or offer to provide additional banking services at lower fees. For example, banks could offer rebates on foreign fees, lock-boxes and other services if corporations deposit their day-to-day funds with the bank.

All told, bank earnings are likely to suffer from having to pay higher interest expenses. Whether banks can pass on these costs to customers is unclear.

FIGURE 4: QUARTERLY CHANGE IN DEPOSITS



Data as of December 31, 2022.
Source: FDIC

Higher Deposit Insurance Coverage

There is historical precedence when it comes to the FDIC expanding the scope of the Deposit Insurance Fund. As part of the response to the 2008 financial crisis, the FDIC created the Transaction Account Guarantee Program (TAGP). Through TAGP, the FDIC provided a guarantee of all funds held in non-interest bearing transaction accounts at participating banks. The program successfully ensured no disruption in deposit flows within the financial sector. Banks had to pay for the insurance with premiums based on the size of deposits insured.

The last time Congress authorized the FDIC to increase the deposit insurance scheme was in October 2008 when the amount insured increased from $100,000 to $250,000.

As the economy has grown since and as businesses' deposit balances are likely larger than those of households, we believe authorities will likely consider raising the deposit insurance limit, possibly closer to $400,000 per account.

In the interim, should deposit flows become problematic for the economy, authorities could consider reenacting the TGAP. However, the Dodd-Frank Act currently prohibits the creation of a future TAGP.

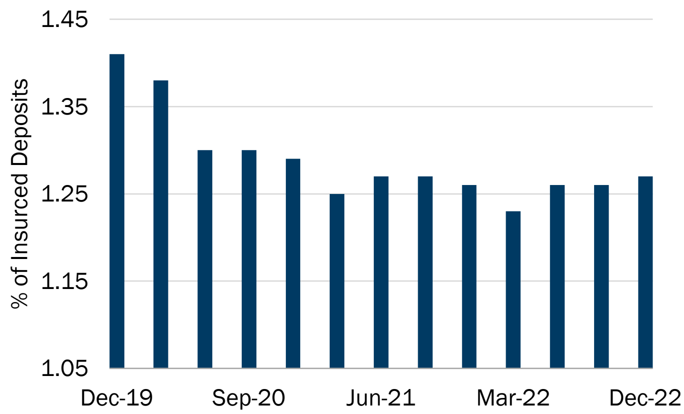
Banking Authorities Can't Afford Many More Failures

US banking authorities cannot afford to have a large number of banks fail. This is not only due to the risk of a lack of public confidence consuming the financial system as well as resulting economic shocks, but also the FDIC has very limited means to cover the losses on the insured deposits of failed banks. The Deposit Insurance Fund had a balance of just $128bn at the end of 2022, which effectively covers just 0.72% of US domestic deposits; this number excludes recent failures. At the end of 2022, the fund had reserves equal to just 1.3% of system-wide insured deposits, according to the FDIC.

More M&A as Regionals Bulk Up

Regional banks have typically been valued on the strength of their deposit franchise; that is, their ability to attract low cost deposits. For example, Wells Fargo's held total deposits of

FIGURE 5: DEPOSIT INSURANCE FUND AS % OF INSURED DEPOSITS



Data as of December 31, 2022.
Source: FDIC

$1.4 trillion at the end of Q4 2022 of which 65% were interest bearing with a deposit cost of just 70 basis points. This means Wells had close to $500 billion of zero paying deposits. Combining these deposit types means Wells had a total deposit cost of just 46 basis points. Compare this to the yield on a two-year T-Bill and one can see how banks can make money by simply collecting low cost deposits and investing in lower risk assets (but this may create a duration management mismatch, the very risk banks are now learning to better appreciate).

Recent events are testing the thesis that a bank's value can be ascribed to its deposits. Certainly, some deposit types are more valuable than others. As a result, we may see regional banks look to sell themselves and/or bulk up in size to become larger, especially if their deposit base is not durable and comprised of larger uninsured deposits.

More Regulation

Currently, smaller regional banks are not subject to the heightened liquidity rules imposed on the larger banks. For example, smaller banks are not required to mark-to-market their securities portfolios and have fair value changes be reflected in equity.

This will likely change. US regulators are likely to tighten liquidity and capital standards for smaller US regional banks. The more onerous regulatory standards that are applied to the largest US regional banks could be applied to smaller banks. In fact, some of the regulations that applied to smaller banks were eased under the Trump administration.

We may also see more disclosure involving the assumptions banks are making on the duration of their deposits (which are rarely disclosed to investors) and on the duration of their assets (also no standardized disclosure made to investors).

More Debt Issuance

Some of the larger regional banks (with assets of over $250bn) are in the process of being examined as to whether they should be required to issue bail-in-able debt. We expect these rules to be finalized in 2023. This will likely mean larger regional banks will need to issue more holding company senior unsecured debt.

If regulators look to push down the big bank rules to smaller regional banks, smaller regional banks may be similarly required to issue more senior unsecured bail-in-able debt. Furthermore, regional banks may view issuing more senior and subordinated debt as a means to add more durable funding to their balance sheets. Ironically, this may mean the banking industry becomes even a larger part of the credit index.

Capital Raises

We expect some banks may look to issue equity as a preemptive means to shore up weaker capital levels and provide customers with greater confidence. Several of the larger regional banks appear to have somewhat weaker capital ratios versus peers.

Tightening of Lending Standards

It is possible that smaller regional banks now facing tightening funding conditions as well as needing to pay higher interest rates to attract deposits could be less likely to make marginal loans. Such actions spread across the regional banking industry could have an impact on the availability of credit, especially for smaller corporations that cannot access the bond markets. Hence, smaller middle market corporations may suffer from lack of credit availability.

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