Failures, Funding and Financial Resiliency: 1Q 2023 Bank Earnings

Authored by Mark W Kehoe, CFA, Portfolio Manager and Senior Analyst

Bank quarterly earnings are typically quickly forgotten. However, Q1 2023 earnings are likely to be remembered for the focus on deposit migration to large banks from small banks. They also forced investors to consider banks' longer term business model, specifically the resiliency of the regional banking model in an environment of higher interest rates for an extended period, and whether technology is reshaping the relationship regional banks have with their customers.

We prefer to own large banks on account of their diversified revenue and funding streams, adherence to stricter regulations and strong technology/brand presence. However, we believe current market price dislocations present interesting investment opportunities in the larger regional banks that are worth considering.

A More Memorable Quarterly Earnings Season

Quarterly bank earnings are typically quickly forgotten; if you miss one, another quickly follows. But Q1 2023 earnings were an exception given the events that unfolded toward the end of the first quarter.

The first quarter of 2023 saw several bank failures, sizable migration of deposits from smaller banks to larger banks as well as deposit outflows into money market funds and questioning the viability of the regional bank business model. We delve deeper into these topics below.

When we reflect on the quarter, there are two observations we think have longer lasting relevancy.

1. The larger US banks have benefited from greater regulatory oversight. In the past, the management teams of larger US banks bemoaned regulators' demands to adhere to higher liquidity and capital standards. However, in Q1 2023, compliance with these standards meant these banks are now perceived as "safe havens" and consequently attracted deposits that quickly migrated from smaller banks which were perceived as increasingly risky.

Looking forward, regulators are likely to require smaller banks to comply with stiffer regulations to shore up capital and liquidity. Greater regulation could have knock-on effects on the willingness of smaller regional banks to extend credit and increase the pricing of credit.

2. Technology is playing an increasingly important role in defining banking winners and losers and new entrants are emerging. Banks have invested tens of billions of dollars in recent years allowing customers to move money quickly and efficiently around the financial system. At same time, depositors are waking up to higher interest rates on a range of deposit products.

People have historically changed their bank accounts infrequently; however, recent events are likely to alter this behavior. Up until March 2023, the average life of a bank deposit relationship account was assumed to be around 7 years. It is now likely much shorter.[1]

1. Source is Bankdirector.com: Bill Paterson, Sept 17, 2017.

Only by the end of Q1 2023 did we truly appreciate just how technology (including social media) changed customers' views of their banking relationships and how rapidly money can be moved within and outside the banking system.

In light of these changes, banks have had to reflect on how customers value bank brands, including perceptions of banks' financial resiliency and confidence, the very concepts that underpin retail banking. At the heart of banking is trust. Banks take customers' deposits and lend them out often long term. Customers believe their money is safe and can be withdrawn at any time. The recent crisis is testing customers' trust in banks. All this means that banks are seeing their business model being tested.

A recent J.D. Power consumer survey conducted in early April found that 59% of the 4,000 respondents were somewhat or very concerned that banks are not always a safe place to keep their money. More troubling is that 74% of customers under 40 years old are "somewhat or very concerned"[2]. This likely means that younger customers are more open to banking with fintechs.

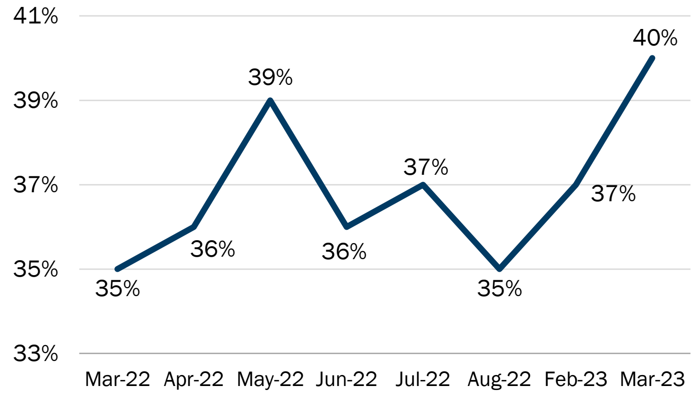
The good news is that customer sentiment has improved. Wells Fargo notes that a survey J.D. Power conducted March 15th to 19th, just after the failures of SVB and Signature Bank, 81% of consumers said that they were "somewhat or very concerned" about the stability of the U.S. banking system and 51% were "somewhat or very concerned" about the stability of their primary bank[2].

Apple recently launched a high savings product which encapsulates some of the broader threats to the banking sector.

The interest rate Apple is currently offering is 4.15%, which is compelling compared to interest rates paid by regional banks. We expect people to become more aware of the benefit of moving deposits to higher interest bearing accounts.

In addition, people have a deep relationship with their phones. Studies show people spend 145 minutes on their smartphones per day[3] and Apple is perceived as the US's most trusted technology brand[4].

FIGURE 1: WHAT % OF YOUR TOTAL PRIMARY BANK ACCOUNT DID YOU MOVE TO ANOTHER BANK?



Source: Bloomberg, April 28, 2023

Combining these two factors, it is not difficult to see the pressures smaller regional banks face to retain customer confidence, including the need to pay up to retain deposits and the investment pressures to strengthen technology offerings and brand presence.

Key Themes from 1Q 2023 Earnings

Below we review three key themes from Q1 2023 earnings and portfolio implications.

FAILURES AND FOLLOW THROUGH

Banks are expected to retain more capital following the failure of banks in both the US and Europe. This likely means less lending.

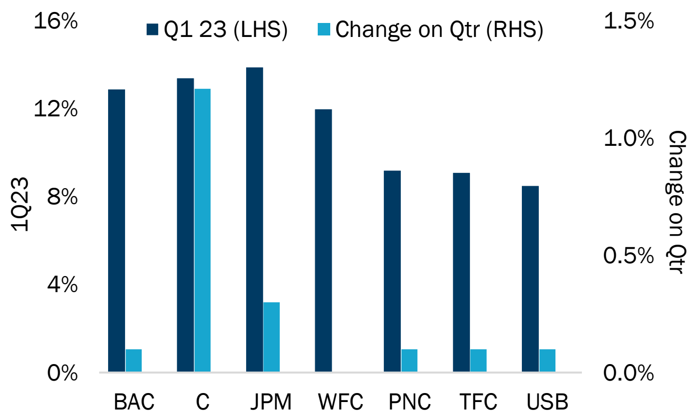
FIGURE 2: ONLINE BANKS OFFER HIGHER DEPOSIT INTEREST RATES

Product	Large Bank	Regional Bank	Online Bank Avg
SAVINGS	0.60%	0.16%	3.04%
CHECKING	0.20%	0.03%	0.25%
MONEY MARKET	1.40%	0.50%	3.08%
1 YR CD	1.02%	1.28%	4.66%
2 YR CD	0.71%	1.10%	4.32%
5 YR CD	0.78%	0.75%	4.04%

Source: Goldman Sachs, April 2023

2. JP Power Data, US Deposits Confidence Survey, April 6-13, 2023, Data Report, April 24, 2023.
3. https://www.brusselstimes.com/232851/people-touch-their-smartphone-over-2600-times-a-day-research-shows
4. https://appleworld.today/archives/101305

FIGURE 3: CAPITAL RATIOS IMPROVED OVER THE QUARTER: COMMON EQUITY TIER 1 CAPITAL (%)

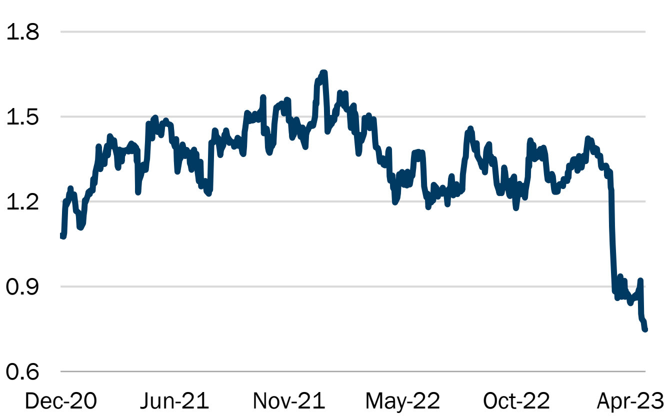


Source: Bloomberg, April 28, 2023

Capital ratios were generally stable in Q1 2023 as banks did not grow assets in the quarter. Banks signaled they are taking a cautious approach to returning capital to investors as uncertainty remains, especially if unrealized losses on securities portfolios grow. JP Morgan noted a desire to keep some dry powder in slowing stock buybacks. PNC also pulled back.

There is no clear view that banks are in need of more capital, aside from the inability of bank equity prices to bounce off recent lows.

FIGURE 4: REGIONAL BANK PRICE TO BOOK VALUES ARE NOW BELOW 1X: MARKET VALUING BUSINESSES LESS THAN STATED EQUITY



Source: Bloomberg, April 28, 2023

However, a significant increase in deposit costs over the medium term and/or higher terminal interest rates could encourage certain banks to reassess taking losses from selling lower yielding investment securities and re-investing the proceeds into higher yield securities as a means to boost net interest margins, and raising equity to offset the loss. Whether banks take such an approach is questionable given the bad experience of Silicon Valley Bank attempting such an endeavor.

Banks may need to retain more capital in order to bolster capital resources over the next few years. Most notably, we expect a now broader group of US regional banks to be subject to stricter capital and liquidity regulations as banks with assets of at least $100 billion are expected to fall under new rules. Previously, increased regulation was planned for banks with assets of over $250bn. New rules will likely include more banks being required to issue bail in-able senior unsecured debt. The issuance of this debt could weigh on prices of regional bank debt.

Lastly, regulators are also said to be looking at the possibility of including unrealized security losses in banks' regulatory capital ratios for both available for sale and held to maturity bond portfolios. This would be phased in over time, giving banks the opportunity to build capital and for bonds to pull to par.

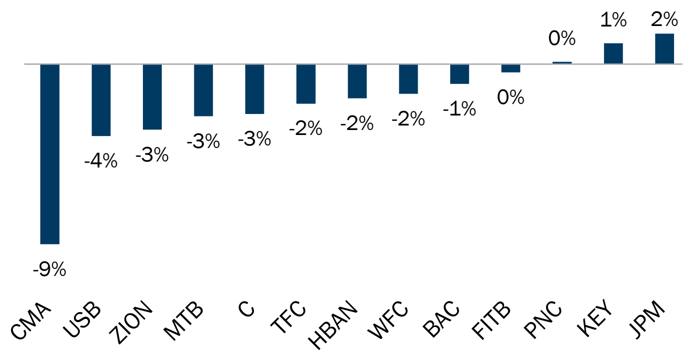
Considering all these factors, banks will likely only look to selectively grow their balance sheets, resulting in a tightening of their appetite to make new and extend existing loans. JP Morgan projects a very large slowdown in bank lending growth (from 12% last year to 2% this year) could be a 0.8%-point drag on GDP growth.

FUNDING: FLOWS TO LARGER FROM SMALLER BANKS: PROFIT HIT TO SMALLER BANKS

Our focus on the quarter was to uncover evidence of deposit migration away from smaller regional banks toward the larger, more regulated banks.

There were signs of deposit migration. Overall industry-wide deposits declined by 3% Q/Q, but the declines were not evenly felt. The larger banks saw declines of just 1% Q/Q. However, the regional banks saw deposits decline by 2%, though the percentage varied with PNC seeing flat deposit growth while Comerica, a commercial bank with a larger uninsured

FIGURE 5: TOTAL DEPOSIT FLOWS: MIGRATION FROM SMALLER TO LARGER BANKS, QUARTER ON QUARTER



Source: Bloomberg, April 28, 2023

depositor base, saw deposits fall by 9% Q/Q. Most striking was that JP Morgan saw deposit inflows of 2% Q/Q reflecting its perceived "safe haven" status. No other banks experienced deposit inflows.

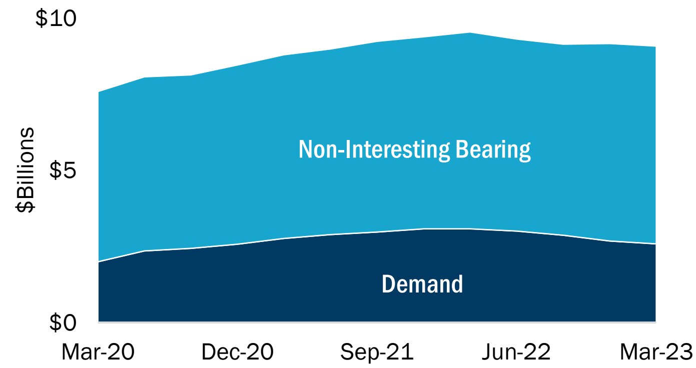
Thus, in spite of a decade's worth of regulatory efforts, there is still the view that the larger banks will receive government support in the event of a crisis. (See Figure 5 above)

Reassuringly for the sector, according to a majority of banks indicated that the larger outflows of deposits following the collapse of Silicon Valley Bank lasted for just a few days and have now abated.

However, banks experienced notable flows from zero or low cost deposit accounts into higher yielding accounts. To retain deposits, banks had to increase interest rates on deposit accounts as depositors woke up to the option of higher interest rates being paid on higher yielding deposit products and alternatives. With the possibility that the Federal Reserve continues to raise interest rates and/or keeps rates higher for longer, the risk is that funding pressures continue, especially as costs of interest bearing deposits for the sector are around 1.8% while T-Bills are yielding around 5% and money market funds over 4.5%. (See Figure 6 above)

According to JP Morgan Research from April 2023, banks across the sector had to increase deposit rates with larger banks experiencing deposit cost increases of .51% to 1.79% while smaller regional banks increased deposit costs by .56%.

FIGURE 6: DEPOSITS ARE BOTH DECLINING AND MOVING TO HIGHER RATE DEPOSIT ACCOUNTS: DEPOSITS OF LARGER BANKS DEMAND VS NON-INTEREST BEARING



Source: Bloomberg, April 28, 2023

As a result, net interest margins were generally pressured, with regional banks experiencing the most pressure with net interest margins down by 7 basis points on average, though some banks like Comercia, Key and Zions saw nearly a 20 basis point contraction. (JP Morgan Research, April 2023)

FIGURE 7: LARGER BANKS NET INTEREST MARGINS DID NOT DECLINE AS MUCH AS THOSE OF SMALLER BANKS

	Q1 22	Q4 22	Q1 23	Q/Q Change (+/-)
MONEY CENTER				
BAC	1.69%	2.22%	2.20%	-0.02%
C	2.05%	2.39%	2.41%	0.02%
JPM	1.67%	2.47%	2.63%	0.16%
WFC	2.16%	3.14%	3.20%	0.06%
AVERAGE	**1.89%**	**2.56%**	**2.61%**	**0.06%**
SUPER REGIONAL				
PNC	2.28%	2.92%	2.84%	-0.08%
TFC	2.76%	3.25%	3.17%	-0.08%
USB	2.44%	3.01%	3.10%	0.09%
AVERAGE	**2.49%**	**3.06%**	**3.04%**	**-0.02%**
REGIONAL				
CMA	**2.19%**	**3.74%**	**3.57%**	**-0.17%**
CFG	2.75%	3.30%	3.30%	0.00%
FHN	2.37%	3.89%	3.87%	-0.02%
FITB	2.59%	3.35%	3.29%	-0.06%
HBAN	2.88%	3.52%	3.40%	-0.12%
KEY	2.46%	2.73%	2.47%	-0.26%
ZION	**2.60%**	**3.53%**	**3.33%**	**-0.20%**
AVERAGE	**2.55%**	**3.44%**	**3.32%**	**-0.12%**

Source: JP Morgan April 2023

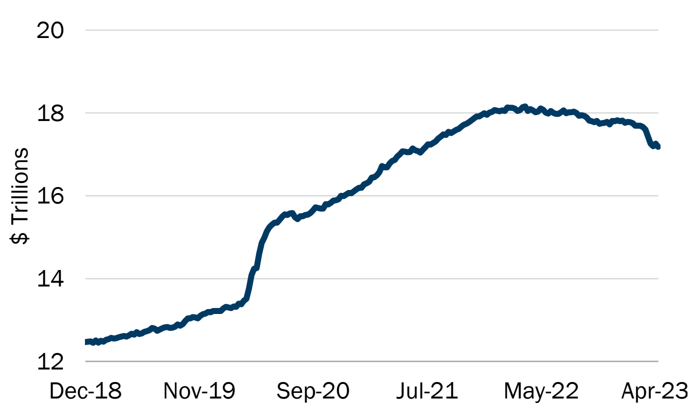
Funding costs are likely to remain elevated for the foreseeable future as the Federal Reserve keeps rates higher for longer, which likely means banks' profitability will suffer. Profitability could be more pressured for smaller regional banks as net interest income contributes more than two-thirds of their revenues.

An investor concern is that banks will need to increase deposit rates closer to money market yields. However, using history as a guide and taking the view that depositors derive more value from their bank accounts than just earning interest, it is likely that deposit costs could increase to around 50% of Fed Funds. This would mean overall deposit costs would move from current levels of around 1.15% to 2.50%-2.75%. This would certainly materially impact profitability. JP Morgan estimates average return on equity could be lowered by 7 points for the smaller banks.

Deposits are also leaving the financial system as the Federal Reserve implements Quantitative Tightening and COVID stimulus savings are consumed. It is worth remembering that COVID induced stimulus programs created a $2 trillion increase in deposits. If we assume the entire COVID deposit bump were to outflow, this would imply a 10% reduction in system-wide deposits from the 2021 peak. We are likely already 50% there as around $1 trillion of surplus deposits remain in accounts, and JP Morgan estimates some regional banks have already experienced at least a 10-12% decline in deposits.

It is worth mentioning that there was virtually no loan growth across the banking sector in Q1 2023. Looking forward, loan growth expectations were lower by several smaller regional banks on account of lower deposit growth outlooks. Specifically, loan growth expectations were reduced from mid-to-high single digit growth rates to mid-single digit. There is a lot of focus on whether regional banks are pulling back on lending given deposit outflows, higher deposit costs and the need to retain capital given pending regulations. Bank management teams pointed to scaling back exposure to commercial real estate, notably office, given concerns of weaker appraisal values and shrinking debt service coverage ratios (see below for more details).

FIGURE 8: TOTAL SYSTEM-WIDE DEPOSITS ARE FALLING



Source: Federal Reserve Economic Data (FRED), April 2023

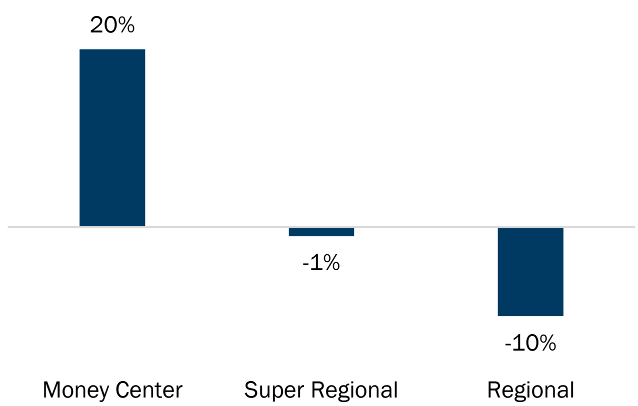
Financial Resiliency of the Larger Banks: Office CRE a Focus

Bank credit investors want banks to be profitable as profits act as a first line of defense.

Similar to deposit trends, larger banks outperformed their smaller peers in terms of profitability as strong net interest income and capital markets businesses underpinned revenues. The diversification of revenues across business lines is a source of strength for large banks.

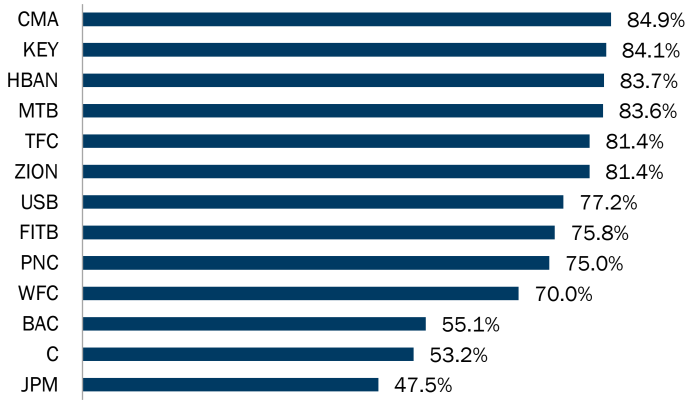
Profitability can be measured by pre-tax pre-loan loss provision revenue (PPNR). The larger banks saw PPNR increase by almost 20% q/q while smaller regional banks experienced a decline of 10% on average, from a combination of lower interest income and fees.

FIGURE 9: LARGER BANKS' PRE-TAX PRE-PROVISION REVENUE ROSE WHILE REGIONAL BANKS' FELL (% Q/Q)



Source: JP Morgan, April 2023

FIGURE 10: LARGER BANKS' LOAN TO DEPOSIT RATIOS ARE BETTER THAN SMALLER BANKS



Source: Bloomberg, April 28, 2023

We believe the size of larger banks confers natural advantages, including broad funding bases where deposits are just one source of funding and loan to deposit ratios are less than 60% vs. regional peers at over 80% (see Figure 10 above). Combined, these factors make larger banks more resilient to stresses.

Lastly, a growing topic of investor interest is banks' exposure to commercial real estate, especially the office sector.

Bank management teams pointed to additional weakness in the office sector with a rising level of criticized assets. Overall, there is approximately $100 billion of annual office loan maturities through 2027. This likely plays out over time rather than as one cataclysmic event, as lenders can work with borrowers to find solutions.

Looking at some specific banks, for example, PNC has 2.7% of loans tied to offices and it noted that criticized loans within its office loan portfolio stood at 20% and that multi-tenant loans, of which office represents 58%, have a mid-70% occupancy range. Wells Fargo noted it is de-risking its office portfolio; however, it is not seeing signs of stress, at least in the near term. Wells Fargo has 3.8% of its loans tied to offices.

Our broader concern is with the smaller banks. Banks with assets of less than $100 billion hold 65% of the banking sector's total exposure to commercial real estate.

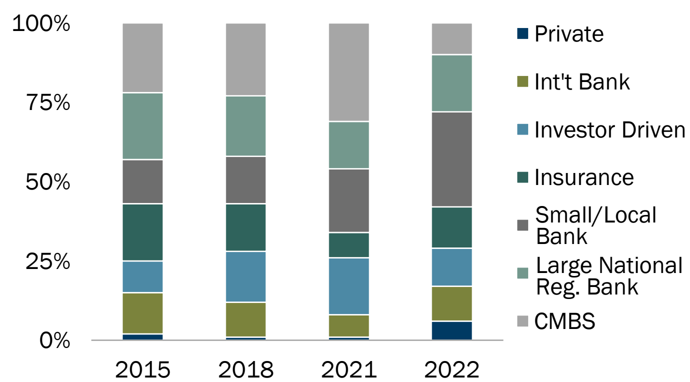
FIGURE 11: BANKS OFFICE EXPOSURE ($ AND % OF LOAN BOOKS)

	Office CRE ($ BN)	Office/ Total CRE (%)	Office/ Total Loans (%)
KEY	$1.0	5%	1%
JPM	$10.8	10%	1%
CMA	$0.6	7%	1%
C	$8.0	15%	1%
FITB	$1.6	15%	1%
TFC	$5.2	18%	2%
BAC	$18.7	26%	2%
USB	$6.8	12%	2%
RF	$1.8	12%	2%
PNC	$8.9	25%	3%
ZION	$2.2	17%	4%
MTB	$5.2	12%	4%
WFC	$35.7	23%	4%

Source: Wells Fargo April 2023

Furthermore, over the course of 2022, smaller banks made up 30% of office lending, up from 20% in 2021. This poses the risk that smaller banks are exposed to more regional and lower quality property types where asset values may be at more risk from impairment.

FIGURE 12: CMBS, BANKS, INSURANCE HAVE AVERAGED 85% OF OFFICE LENDING SINCE 2015



Source: Goldman Sachs, April 2023

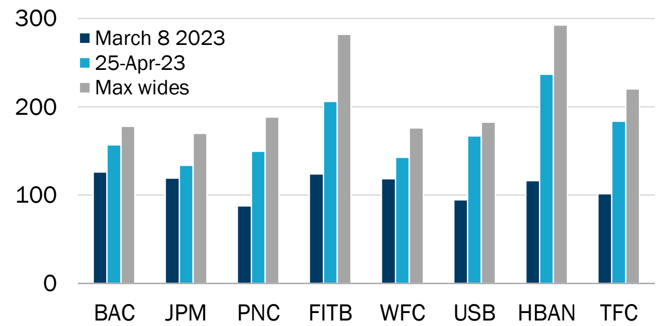
Portfolio Implications

We favor owning larger banks with diversified revenue and funding sources. Typically these are the G-SIBs, the globally systemically important banks. We believe these banks benefit from scale in terms of a broad range of revenue streams as well as being required to adhere to more stringent liquidity and capital ratios.

However, we believe the recent underperformance of some larger regional banks has created compelling investment opportunities, especially in names with strong retail deposit franchises, capital resiliency and less exposure to weakening commercial real estate sectors. With greater regulation to be imposed on larger regional banks, we expect the valuation disconnect that has currently opened to close in due time.

At the same time, we remain watchful of the broader implications of the smaller regional banks curtailing credit creation and whether this restricts the ability of smaller companies to expand.

FIGURE 13: REGIONAL BANKS' CREDIT SPREADS ARE STILL WIDE: BANKS 5 YEAR SENIOR UNSECURED CREDIT SPREADS, MARCH 8 2023, APRIL 25, 2023



Source: Bloomberg, April 28, 2023

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ICE BOFA HIGH GRADE EMERGING MARKETS CORPORATE PLUS INDEX

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