AEGON Asset Management

Banking Sector Update

March 13, 2023

Please see below for a summary of the recent bank closures and our views on market implications.

Silicon Valley Bank

Silicon Valley Bank (ticker: SIVB) is the 16th largest US bank and represents the second largest bank failure in US history. SIVB is a large regional bank with approximately $200 billion in assets. It has a niche business strategy focused on serving venture-backed firms, primarily in the San Francisco Bay area (~97% of deposits). The company has higher sector and borrower concentrations as it focuses on emerging growth and middle-market growth companies, primarily within the technology and life sciences industries. Given the nature of its commercially focused client base, the vast majority of deposits are not FDIC insured and, therefore, highly sensitive to market confidence.

Overall, the company's demise appears to have been the result of asset-liability mismanagement. The bank was mostly invested in highly liquid Treasury bonds and mortgage-backed securities, which it had acquired at low interest rates. The sharp rise in interest rates in the past year resulted in a decline in their market value. The combination of a slowdown in venture capital activity and rising interest rates apparently caused accelerating deposit outflows over the last few quarters. The company reported a 13% decline in deposits (~$25 billion) from the peak on March 31, 2022, through December 31, 2022. It likely experienced continued outflows quarter-to-date in 2023. To cover the fall in deposits, SIVB had to sell liquid assets, and thereby realized these losses.

The company recently announced it realized $1.8 billion in losses from $21 billion in available-for-sale (AFS) security sales, representing about 80% of its AFS portfolio. The company unraveled quickly as a bank run occurred, an attempt to raise capital failed and the FDIC seized the bank on March 10.

Signature Bank

Signature Bank (SBNY), a regional bank based in New York with roughly $110 billion in assets, was also seized by regulators on March 12. Like SIVB, SBNY also had a high level of uninsured deposits, however, it did not have the same degree of unrealized losses on its securities book relative to capital.

Regulatory actions

To restore confidence and prevent additional bank runs, the US Treasury Department, Federal Reserve and FDIC announced swift emergency measures on March 12. This included guaranteeing uninsured deposits at SIVB and SBNY. In addition, funding will be available to banks via a new Bank Term Funding Program. This repo facility provides loans for up to one year to banks that pledge US Treasuries, MBS, other qualifying assets with no haircuts. The Fed views this funding program as a circuit breaker to deposit flight risk.

Contagion risk and banking sector implications

At this time, following the Fed's action, we believe the contagion risk in the broader financial sector should be limited. We see the failures of SIVB and SBNY as mostly isolated cases. Their issues primarily stemmed from elevated uninsured deposits as well as asset-liability mismanagement and/or concentrated business models. Unlike the financial crisis in 2008, these recent failures were not related to an asset quality problem. We believe US regulators took appropriate steps to proactively address the risk of systemic bank runs. Although the goal is to restore confidence, time will tell if it helps reassure depositors.

Most banks have higher than normal levels of deposits built up during the pandemic, which were largely invested in high-quality, liquid securities. Due to the rapid rise in interest rates, many banks have material unrealized losses in their available-for-sale or hold-to-maturity securities portfolios. At the same time, banks are also facing a reduction in deposits on the liability side of the balance sheet as customers seek out higher rates. As excess deposits run off, banks may be forced to liquidate their securities holdings and realize losses. The deposit mix for banks is important, with a distinction between insured and uninsured deposits, as well as the assumed duration of various deposit types. Banks that would be of greater concern include those with higher deposit flight risk, which we define as elevated uninsured deposits as a proportion of liabilities.

Beyond the immediate liquidity concerns related to higher interest rates and the unrealized losses on securities portfolios, there could be various second-order implications. Firstly, banks may face higher competition for deposits and funding, which will impact net interest margins and earnings. Secondly, US and European banks could take a more cautious stance on liquidity management and make more careful decisions about deposit pricing and loan growth. As a consequence, tighter financial conditions could develop and in turn, lead to greater asset quality deterioration.

Separately, over the medium term, we anticipate greater regulatory scrutiny on certain US regional banks. This will likely encompass extending certain liquidity, funding and capital requirements by regulators to regional banks that currently only apply to the largest US banks.

With regards to European banks, we believe the contagion risk is limited. Due to the regulatory framework, European banks have limited asset-liability risk and much lower unrealized losses. Additionally, the deposit structure in the region is more retail-oriented with lower competition.

Overall, we believe deposit flight risk and market confidence remains the primary focus for markets. However, this environment does warrant caution. We are continuing to scrutinize our banking holdings and analyze broader sector implications with a focus on risk management.

Macro implications

From a macro perspective, tight monetary policy eventually creates financial stress points. We are starting to see the impacts of rising rates, however we have not yet witnessed the full magnitude of second-order effects stemming from aggressive monetary tightening.

The direct implications of tighter financial conditions clearly include higher funding rates for credit and a decline in household wealth. This affects aggregate demand, which can result in contractionary and deflationary forces. The indirect ramifications include confidence issues and heightened uncertainty. A surge in uncertainty can weigh on future spending and investment. Both effects are typically net-contractionary and disinflationary to the economy.

That said, the level of influence on the macro environment and monetary policy will depend on the level of contagion. In our view, the outcome is somewhat binary, depending on if contagion is quelled or spreads. At this point, we expect the Fed will stay on the path of hiking rates to tame inflation, provided contagion doesn't spread further. We continue to expect a recession in the back half of 2023. If we witness more contagion, which is not our base case, the timing of this recession could be accelerated.

We will continue to closely monitor the evolving situation. Please let us know if you have any additional questions.

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