



U.S. Banking System: Should Investors Withdraw Their Concerns?

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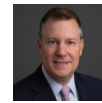
The collapses of both Silicon Valley Bank (SVB Financial) and New York's Signature Bank have some investors worried about systemic risk in the banking system and its impact on the domestic economy—but are these concerns warranted? Two of our financial sector investment analysts recently addressed those questions and discussed their outlook for the banking industry with Steph Jackson, the head of T. Rowe Price Investment Management.

The recent failures of Silicon Valley Bank (SVB) and Signature Bank stemmed from different causes than the collapses experienced in the banking system during the global financial crisis (GFC) of 2008–2009

- The majority of bank failures are caused by either significant problems in a bank's loan portfolio or a liquidity crisis, commonly known as a run on the bank.
- In the GFC, major problems with banks' loan books—particularly with the credit quality of their real estate lending—triggered a wave of bank failures.
- In contrast, liquidity crises caused the failures of SVB and Signature Bank as depositors raced to withdraw their funds.
- SVB's balance sheet investments in long-term fixed income securities lost value amid the Federal Reserve's rate hikes, compounding its problems.

The Fed's monetary policy tightening has created an environment where investors may draw down their bank deposits, but the relatively unique characteristics of SVB made its deposit pressure more acute

- The Fed's rapid rate increases and quantitative tightening have raised yields available on short-term investment vehicles such as short-term bonds, giving investors incentives to draw down bank deposits.
- Start-up technology companies dominated SVB's customer base, and the recent pullback in funding from venture capital firms boosted these customers' cash needs, causing them to withdraw deposits.
- The increasingly connected world via social media likely accelerated the bank runs experienced by SVB and Signature.



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- SVB's deposits dropped 25% in a single business day, a remarkable decline.
- Because banks do not hold deposits dollar for dollar, there is still some concern about the potential for deposit flight.
- However, during the GFC the Federal Deposit Insurance Corporation (FDIC) explicitly insured all non-interest-bearing bank deposits, and it could do so again to prevent bank runs.

The recent pressure on the share price of European banking giant Credit Suisse is not directly related to the bank failures in the U.S., but it has indirectly contributed to the unease about the global banking system

- The lack of confidence in Credit Suisse is due to weaknesses in its financial accounting, which could become a trigger for liquidity issues.
- While the timing of the issues with Credit Suisse makes it appear that it could be related to the failures of the two banks in the U.S., we view that as a coincidence that has nevertheless contributed an element of banking sector contagion to the environment.

When considering what other U.S. regional banks might be vulnerable to a liquidity crisis, we pay close attention to banks' deposit bases

- We are concerned about banks that have both a high percentage of deposits greater than USD 250,000, which are not insured by the FDIC, and large concentrations of deposits from clients in particular industries.
- While regulators are likely to implement liquidity rules for smaller banks, we also scrutinize bank balance sheets to determine which firms have the ability to sell assets to cover any major drawdowns in deposits.

We see no fundamental impact or contagion from the recent bank failures affecting money market mutual funds

- Doug Spratley, a T. Rowe Price Associates, Inc. fixed income portfolio manager, believes that the obligations of banks that are approved for purchase by U.S. money market funds have better capital and reserves positions to handle outgoing deposits.

- He thinks the largest impact money market funds will face is the change in the path of future interest rates, with the terminal rate (highest point in this tightening cycle) now forecast to be lower than expected before the SVB and Signature failures, and rate cuts now anticipated to come earlier.

We think that the Fed will demonstrate its focus on controlling inflation with rate hikes despite the recent bank failures

- The central bank's new bank term funding program (BTFP) facility, which allows banks to borrow from the Fed while posting Treasuries or other government-related debt as collateral, should allow banks to meet their liquidity needs in the short term.
- Our view is that the Fed will raise the federal funds rate by 25 basis points (0.25%) at its March meeting to demonstrate its inflation-fighting credentials.
- There is the potential for the central bank to overtighten or keep rates too high for too long, creating more economic volatility, but that could create opportunities for active portfolio managers.

When looking for opportunities in regional banks, we focus on the size and quality of banks' deposit bases

- Over half of bank lending in the U.S. comes from institutions with less than USD 250 billion in assets, so the regional banking industry is essential to the broader economy.
- Although bank stocks are likely to struggle in the short term, there are always some stocks that are indiscriminately punished when industries are hit by crises like this.
- Banking is a unique industry in that liabilities drive the franchise value, so we are looking at deposit sizes, concentration, and the proportion of deposits that are insured.
- We are working hard at understanding how we can most effectively position our clients to maximize their risk/reward in two to three years by finding regional banks that have strong balance sheets and healthy liquidity but whose valuations have been caught in the downdraft.

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