PGIM Quant Multi Asset: What's Next for Regional Banks?

Silicon Valley Bank (SVB), a commercial bank headquartered in California, collapsed on March 10, resulting in the second-largest bank failure in US history. The firm had announced a plan last Thursday to raise $2bn in capital, but failed to find new sources, sending its stock plummeting 60% with another 60% pre-market decline early Friday morning. The bank was subsequently shut down and put in FDIC receivership. While SVB is the first US bank to fall into crisis as a result of the current Federal Reserve (Fed) rate hike cycle, other interest rate sensitive sectors of the economy, such as housing, have also been slowing following the Fed's aggressive posture, which has taken the fed funds rate from 0-0.25% in early 2022 to 4.5-4.75% currently (as of 3/14/2023).

Most SVB deposits were invested in longer-dated bonds and mortgage-backed securities, which resulted in significant unrealized losses as long-term interest rates rose in response to Fed tightening. Moreover, the high share of uninsured depositors—largely composed of corporations and venture-backed startups—resulted in a deposit base that was especially prone to pull deposits in response to these concerns.

On March 12, US regulators announced all SVB depositors would be made whole. The operation will not be directly funded by taxpayers; instead, a special assessment will be levied on banks. In addition, the Fed announced a Bank Term Funding Program (BTFP) that will lend to eligible institutions at favorable terms.

Broadly, the failure of SVB, Signature Bank, and Silvergate Bank over the past week appear to be the result of deposits concentered in the technology or crypto sectors, as well as classic mismanagement of assets and liabilities with an unusually large proportion of assets held in fixed income securities instead of traditional banking loans.

The new BTFP facility, along with the FDIC's commitment to protect all depositors, will likely provide assurance to depositors and help curb the outflow of deposits. Still, we expect depositors at smaller institutions will reassess the safety of their capital, despite the assurances from the Fed and FDIC. Significant deposit moves to larger and more stable tier-1 banks would have ramifications on the solvency of smaller institutions. A key risk is that a loss of depositors' confidence could result in capital flight and evolve into a collapse in counterparty confidence.

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On the assets side, the good news is that the current predicament is due to a duration mismatch (which is relatively easier to fix), rather than credit quality (which was the case during the Global Financial Crisis). Banks' unrealized losses have largely been driven by the unprecedented rise in policy rates and not by poor lending decisions. The Fed's funding window eases the liquidity pressures on banks with further room to be extended as needed.

In our view, the immediate economic fallout appears to be less than previously feared, amid significant uncertainty about the status of uninsured deposits. However, bank lending standards have been tightening in the past few quarters, and any further measures by banks to shore up balance sheets could result in additional lending restrictions, which would have material adverse impacts on the real economy.

Despite the additional complexity of bank failures, the Fed is still combatting significant inflationary forces. While the immediacy of a banking crisis could give the Fed an excuse to pause hikes or dial back rate increases while monitoring the stability of financial institutions, the Fed will likely refocus on inflation as market jitters ease. In the short term, markets are likely to remain apprehensive about banks with similar vulnerabilities to SVB, which will likely keep banks with large uninsured deposit bases, larger retail/concentrated deposits, or with a significant proportion of Held-to-Maturity securities under pressure.

Therefore, we think the focus in the coming weeks is likely to be how successful the Fed and others have been in maintaining confidence among depositors and investors in the US banking system, and to what extent the responses by banks to the fast-changing environment could negatively impact the real economy. Regardless, the consequences of the Fed's interest rate hikes, intended or not, are being increasingly felt in the economy.

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