Manulife Investment Management

Investment Note

15 March 2023

Bank stocks have come under pressure after the failure of multiple banks in just a few short days. In this investment note, Ryan Lentell (Portfolio Manager) and Susan Curry (Senior Portfolio Manager) from the US bank portfolio management team highlight what happened and how it affects their outlook for the industry moving ahead.

Regional bank failures create potential risks and opportunities for investors

Regional banks have been rocked over the past week as U.S. authorities shut down two banks in just a matter of days, marking the first bank failures since 2020 and some of the largest since the 2008 financial crisis.

Bank run sinks lender to start-ups

On March 9, 2023, a tech-focused lender announced a restructuring of its $21 billion available-for-sale bond portfolio meant to raise cash and shift its balance sheet toward assets with a shorter duration while improving its future earnings. The sale of the securities, concentrated in long-dated bonds, resulted in an estimated $1.8 billion loss.

The company's management told investors that this restructuring should improve future earnings by $450 million annually by allowing them to reinvest proceeds into higher-rate bonds. Despite this positive guidance, investors declined to participate in the $2.25 billion common and convertible capital raise and customers lost confidence in the bank, which led to a significant sell-off in its shares. By midday on March 10, the Federal Deposit Insurance Corporation (FDIC) closed the bank and released a statement to protect insured depositors.

Crypto winter leads to voluntary liquidation

The second piece of news to cause ripples within the banking community was the voluntary liquidation of a bank that had been a key intermediary in the cryptocurrency industry. The bank had been the primary bank for a recently collapsed crypto exchange that accounted for over 10% of its deposit base. With the crypto exchange's demise, the bank had been under pressure since last fall.

Additionally, the bank's role within the crypto industry meant that the broader downturn in crypto had caused the bank to see a sharp drop in deposits from other clients. Pressure from regulators for banks to reduce their crypto exposure also caused a further drawdown on deposits.

In response, the bank made the decision to self-liquidate, returning all money to depositors with any remaining funds to be returned to shareholders; however, there's significant speculation about what will be left for equity holders given the current volatile environment.

As panic spreads, another bank falls

As the news concerning these bank failures spread, panicked customers at other niche banks began to withdraw their funds. By late Sunday, a New York-based bank had been taken over by regulators, making it the third bank failure in just a matter of days.

This entity had also played a large role in the cryptocurrency industry and acted as one of the largest lenders in the space, amplifying customers' fears and prompting a run on the bank's deposits.

The Fed's response so far has been encouraging

In an effort to halt further contagion and quell fears around risks to other banks, the U.S. Federal Reserve (Fed) released a statement on Sunday announcing an

emergency lending facility to "help assure banks have the ability to meet the needs of all their depositors." The creation of the Bank Term Funding Program will allow for loans of up to one year to banks and other eligible depository institutions, allowing them to pledge U.S Treasuries, agency debt, and mortgage-backed securities as collateral. Notably, these assets will be valued at par, reducing the need for banks to sell these securities at a loss.

At the same time, the U.S. Department of the Treasury, the Fed, and FDIC released a joint statement announcing a systemic risk exception for two of the banks, guaranteeing that all depositors at these institutions would be fully protected. The cost for this is to be funded through the Deposit Insurance Fund (DIF), a pool of money that's funded through quarterly assessments on insured banks. Any losses to the DIF are to be replenished by a special assessment on banks, with no costs to be borne by taxpayers.

The Fed stopped short of creating a broader safety net for other regional banks—something within its power to do. This more definitive response may not ultimately be needed, but its absence will mean the market likely remains volatile in the near term.

Market reaction creates risks and potential opportunities

Although these extraordinary measures show regulators' concern around the risk of financial contagion, the efforts stopped short of guaranteeing deposits for the banking industry as a whole. In response, bank stock prices continued to be under significant pressure on Monday as investors worked to digest the rapid flow of news.

Some depositors clearly remain unsettled, which could lead to pressure on deposits with balances over $250,000 as they seek stability with banks believed to be safer; however, the steps by the Fed have provided banks with new tools to manage through today's potential liquidity challenges.

We also feel that the volatility is creating investment opportunities for an industry that's generally characterized by well-capitalized companies with limited delinquencies and strong balance sheets. The market action is creating dispersion among select bank stocks, with some seeing additional selling pressure and others seeing stabilization.

In our view, many of the issues faced by the now-shuttered banking entities are likely specific to these institutions due to their high concentration in industries that were facing significant funding, regulatory, or legal pressures. Some banking stocks that are coming under pressure today don't face that same issue, having customer bases that are diversified across many industries, which reduces their liquidity risk. Additionally, we believe that most banks have assets that have benefited from higher interest rates.

Undoubtedly, deposit pricing pressure accelerated in the fourth quarter as the Fed continued to raise rates. We also expect there to be industry consolidation as some competitors are taken out of the market.

Although we can't say for certain how long investor concerns around regional banks might persist, we believe this spate of volatility presents an opportunity to allocate toward well-capitalized institutions that have rate-hedged portfolios and a diverse deposit base. In our view, banks that can maintain a strong liquidity profile and benefit from the higher rate environment have the potential to generate a strong return on equity.

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Manulife Investment Management

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