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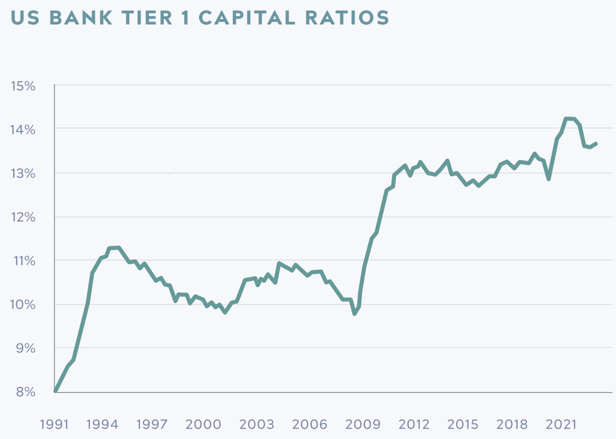
SPECIAL REPORT

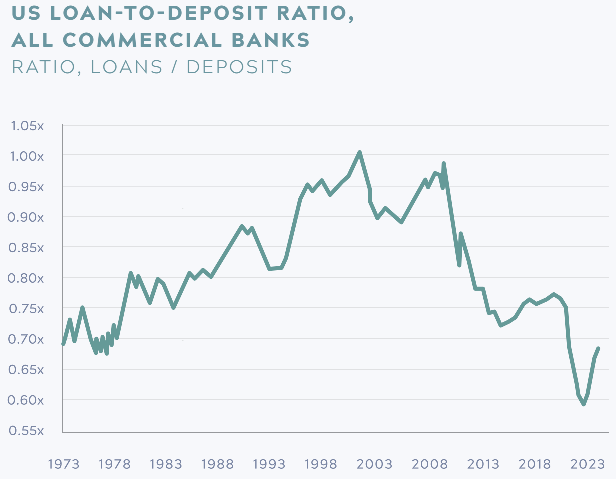
An Update on U.S. Banks

Dear Client,

We're writing to offer our perspective on the recent failures of Silicon Valley Bank (SIVB) and Signature Bank (SBNY). Most bank failures historically have been caused by credit risk issues, but SIVB and SBNY were unique cases where mismanagement of interest rate risk – combined with a run on deposits – deemed both banks insolvent in just a matter of days. As we'll explain below, these two banks were largely in a league of their own in terms of their exposure to risk, which is one of the reasons we do not think financial contagion is likely.

Another reason not to fear a new financial crisis, in our view, is that the U.S. banking system is extremely well-capitalized, with Tier 1 capital ratios at very solid levels and loan-to-deposit ratios at almost their lowest levels in 50+ years (see charts on the next page). By these key measures, the banking system is arguably the strongest it's been in decades.





Source: JPMorgan[i]

Nearly all large banks have the ability to meet withdrawal requests without selling illiquid assets or fixed income assets at losses, and many are actually benefitting from deposit flows as clients leave a few key regional banks[ii]. In our view, the relative stability of the broad US stock market over the past week is emblematic of the underlying strength of the financial system, even though media narratives often seem to suggest otherwise.

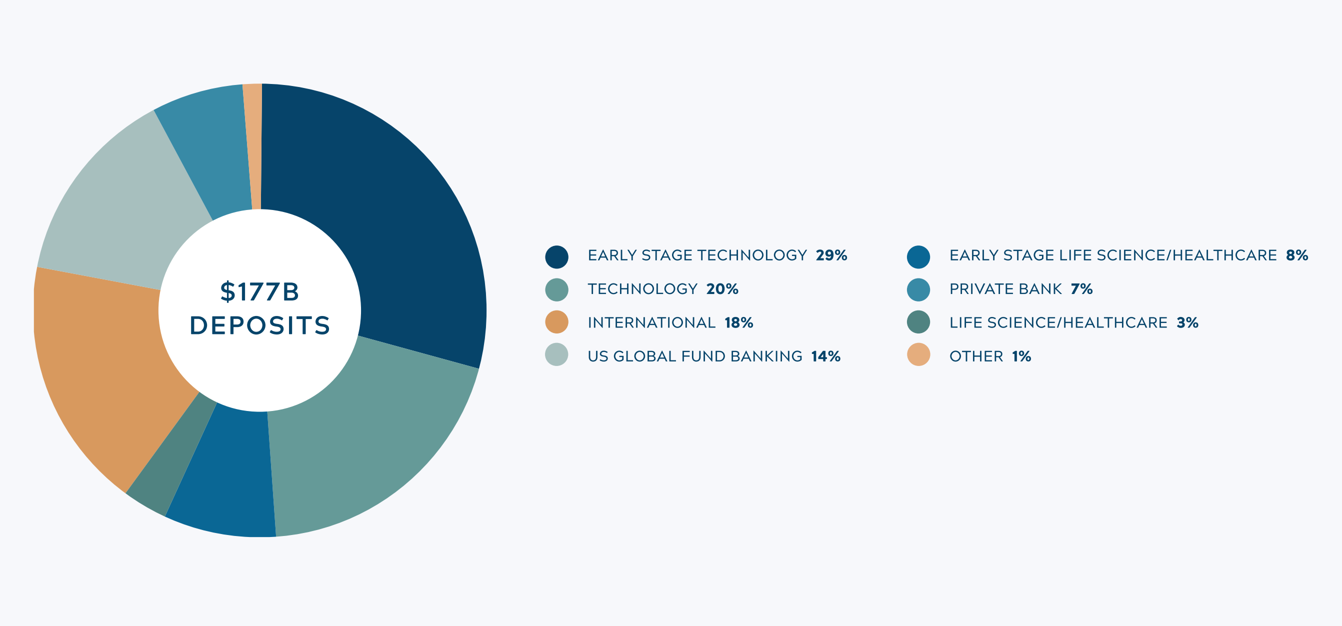
Our overarching message to clients: we see very little risk of a financial crisis, and strongly believe now is a time to remain patient.

What Happened to Silicon Valley Bank (SIVB) and Signature Bank (SBNY)?

Between Q4 2019 and Q1 2022, deposits at US banks went up by $5.4 trillion[iii], a result of massive fiscal and monetary stimulus programs. Nearly all banks saw deposit inflows, but SIVB and SBNY were very unique in terms of deposit growth during this period.

SIVB was a bank that catered mostly to early-stage technology companies, venture capital companies, and private equity firms. In the year following the Covid-19 lockdowns, SIVB saw its deposits surge from $62 billion to $124 billion, a roughly 100% increase at a time when most banks were experiencing 20% to 30% increases in deposits[iv].

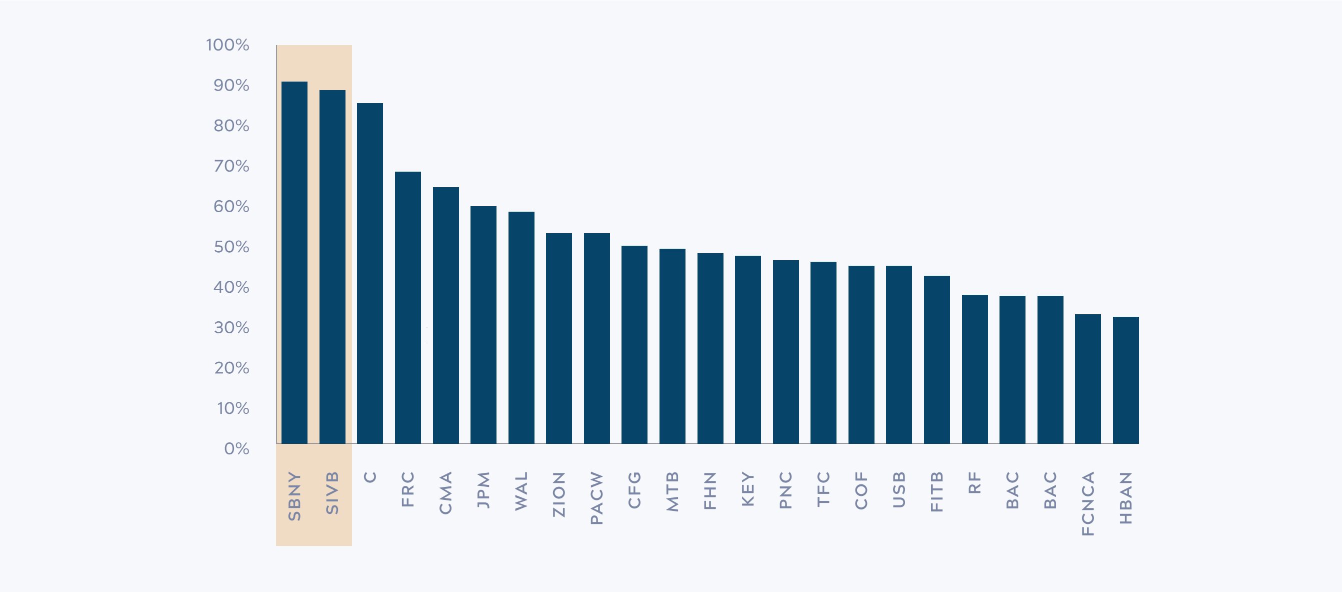
SILICON VALLEY BANK'S DEPOSITS WERE TOO CONCENTRATED



Source: Silicon Valley Bank, Q3 2022

Signature Bank, on the other hand, opened its doors to cryptocurrency companies in 2018. Within a span of three years, the share of crypto industry deposits grew from 0% to 20% of total deposits at the bank . Large clients meant large deposits, and by the end of 2022, 93% and 90% of SIVB and SBNY's deposits were uninsured, respectively.

UNINSURED SHARE OF CUSTOMER DEPOSITS (PERCENT ABOVE FDIC GUARANTEE THRESHOLD)

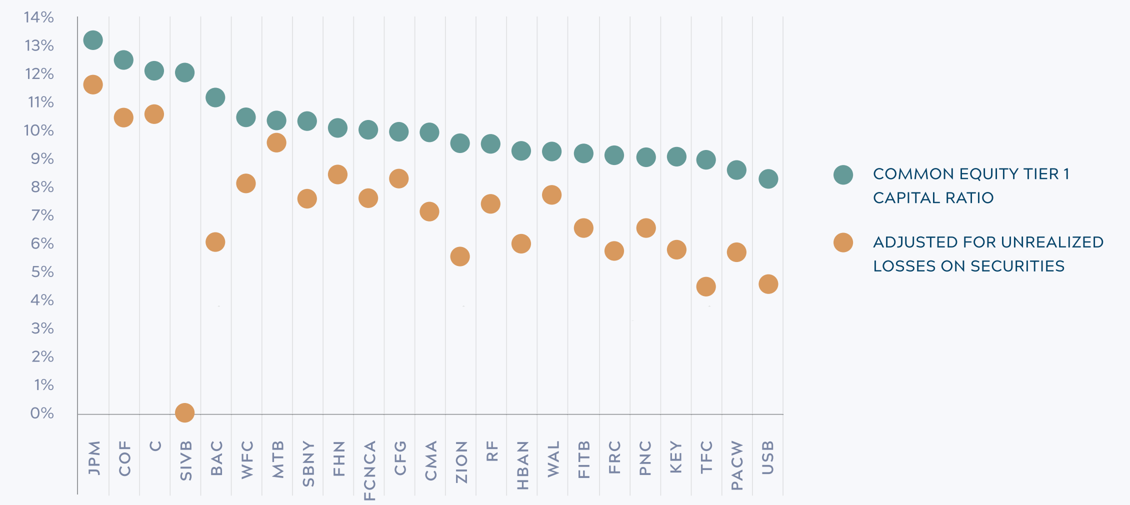


Source: JPMorgan[vi]

This massive, highly undiversified, and heavily uninsured deposit growth came at a time when the fed funds rate was anchored to the zero bound, and US Treasuries were paying 2% at most, but often far less[vii]. Both banks heavily invested new deposits in fixed-rate, long duration Treasuries and other types of fixed income, which while normally a prudent action, turned out to be a matter of terrible timing. Regulators had been warning Silicon Valley Bank of interest rate risk on their balance sheet for a year, but those warnings were largely ignored[viii].

SIVB was in a league of its own: unrealized losses on its books rendered its Tier 1 capital ratio as essentially 0%.

IMPACT OF UNREALIZED SECURITIES LOSSES ON CAPITAL RATIOS



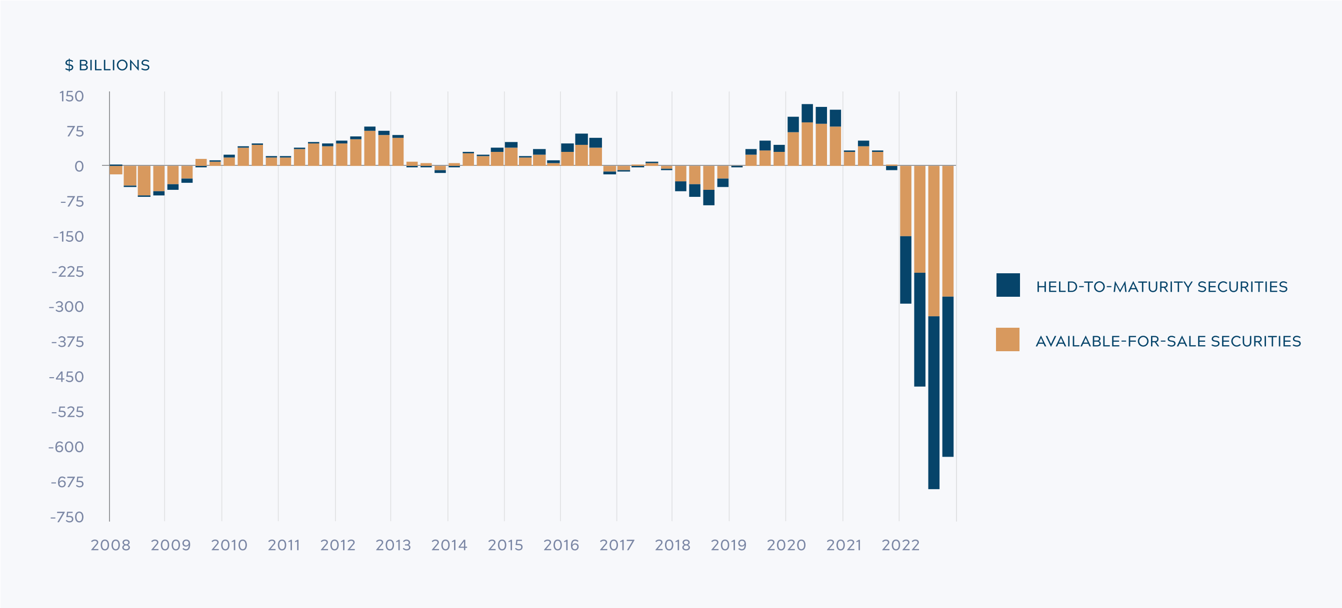
Source: JPMorgan[ix]

Everything came to a head in 2022: interest rates started moving higher, the cryptocurrency industry suffered major setbacks, and the startup world saw funding evaporate. This led many early-stage companies (clients of SIVB) and crypto firms (clients of SBNY) to draw down cash reserves to continue funding operations. This exposed major issues on both the asset and liability sides of the banks' balance sheets:

- **Asset problem:** buying bonds at generational lows in yields, which turned into sizable unrealized losses as interest rates moved quickly higher.
- **Liability problem:** undiversified deposit base that relied heavily on institutional, venture capital, and cryptocurrency funding, versus traditional retail deposits. As big clients started to leave, other large depositors were spooked and followed quickly.

SIVB was certainly not alone in having sizable unrealized losses on investment securities on its balance sheet, however. As seen on the chart below, many banks are underwater on their fixed income portfolios because of the Fed's interest rate campaign, but none (as far as we can see) have the level of duration risk that SIVB had.

UNREALIZED GAINS (LOSSES) ON INVESTMENT SECURITIES



Source: FDIC, Quarterly Banking Profile (Q4 2022)

Investors may look at the chart above and think all banks are in big trouble, but that's not the case. When the Fed stress tests systemically important banks, all unrealized losses in available-for-sale securities are required to be reflected in capital ratios. Held-to-maturity losses are not included in capital ratios, but assuming there is not a run on deposits, a bank is not likely to have to sell those securities at losses to shore up capital. No large banks are experiencing deposit flight, and in fact the opposite has largely been true over the past several days as regional bank customers move money to larger banks[x].

Credit Suisse was another high-profile collapse that worried investors, but problems with the Swiss lender had been evident for months if not years. Unstable management combined with bad bets to hobble the bank, including but not limited to its partnership with now-bankrupt Greensill Capital and its $5 billion loss from the collapse of Archegos Capital Management. Last October, rumors of the banks' problems on social media led to a major outflow of wealthy clients, with deposits falling more than 40% and assets plummeted by 30% in 2022[xi]. Again, failure here was tied more to failures in risk management than systemic problems in the banking sector, in our view.

Regional banks are a different story, which is what is causing ongoing distress in the banking sector and in the media. The question that many investors and depositors are asking about regional banks is: what duration risk did each bank take in its securities portfolio during the deposit surge of 2020 and 2021, and how much of that was invested in debt securities with generationally low yields? These are the questions circulating banks like First Republic, Comerica, Western Alliance, and others. Whether or not these banks can cling to deposits and avoid fear-induced flight may ultimately be the key to survival.

The U.S. Government Response and What Happens Next

Unsurprisingly, the Federal Reserve seemed to sow more chaos than confidence in its response. In our view, the decision to make uninsured depositors whole is likely to have serious implications in the future. As our Co-Portfolio Manager and Director of Research, Jordan Mathews noted, “each time a potentially systemic crisis pops up, the Fed steps-in to provide liquidity and transfer risks onto their own balance sheet, which ultimately sets the stage for the next crisis.”

Expectations are being set that any failed banking institution will have their deposits guaranteed, which seems to warp the entire concept of risk and is arguably another step in the centralization of the financial sector. But that’s a topic for another day.

The Fed went a step further to protect regional banks from insolvency by creating a special emergency facility where debt securities like long duration US Treasuries could be used as collateral (at par value, not fair market value) for loans, giving banks access to liquidity without having to sell securities at a loss[xii]. This facility should stem further failures, but at the same time, whenever the Fed creates new programs it gives the impression there’s a substantial problem, which arguably just exacerbates panic in the short-term.

If regional banks continue to lose customers and more banks fail, the ‘fear factor’ could linger, and lending could be negatively impacted if banks decide a dollar in reserve is safer than a dollar lent. Banks outside of the largest 25 account for 40% of all loan activity, and small banks in particular are responsible for 67% of all commercial real estate lending[xiii]. The economic impact – including the possibility of recession – could hinge on how risk averse small banks become in the coming quarters.

The Federal Reserve appeared to take some of these possibilities into account when they announced a quarter-percentage-point rate increase on Wednesday, March 22. Tighter credit conditions could impact economic growth and hiring to a degree that helps the inflation battle, and the Fed seemed to acknowledge that higher rates could risk creating even more losses on bank balance sheets–which in turn raises the risk of more bank failures. The central bank may be trying to 'thread the needle' by projecting the fed-funds rate to settle around 5.1% by the end of the year, implying one more quarter-point increase[xiv].

We will discuss our outlook from here in more detail in our Q2 2023 client review. In the meantime, if you have any questions or concerns about the markets or your portfolio, please do not hesitate to reach out to us. As always, we thank you for your continued confidence in Ascension Capital.

Sincerely,

Paul Thompson, Jr CFP

Ascension Capital Advisors

Sources:

[i]Source: Eye on the Market, JPMorgan, "Silicon Bank Failure," March 10, 2023
[ii]Source: Marketminder.com, "Putting the Regional Bank Scare into Perspective," March 16, 2023
[iii]Source: Eye on the Market, JPMorgan, "Silicon Bank Failure," March 10, 2023
[iv]Source: Eye on the Market, JPMorgan, "Silicon Bank Failure," March 10, 2023
[v]Source: New York Times, "Risky Bet on Crypto and a Run on Deposits Tank Signature Bank," March 12, 2023
[vi]Source: Eye on the Market, JPMorgan, "Silicon Bank Failure," March 10, 2023
[vii]Source: U.S. Department of the Treasury
[viii]Source: Bloomberg, "The Fed was Too Late on SVB Even Though It Saw Problem After Problem," March 17, 2023
[ix]Source: Eye on the Market, JPMorgan, "Silicon Bank Failure," March 10, 2023
[x]Source: Marketminder.com, "Putting the Regional Bank Scare into Perspective," March 16, 2023
[xi]Source: The Wall Street Journal, "Credit Suisse, the Risk-Taking Swiss Bank Giant, Succumbs to Crisis," March 19 2023
[xii]Source: Federal Reserve
[xiii]Source: The Wall Street Journal, "Banking Turmoil Tests the American Consumer," March 21, 2023
[xiv]Source: The Wall Street Journal, "Fed Raises Rates but Nods to Greater Uncertainty Due to Banking Stress," March 22, 2023.

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