Equity Perspectives

An Ameriprise Investment Research Group publication

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Idiosyncratic vs. Systemic

Following Silicon Valley Bank's (SVB) insolvency there is a lot of speculation and uncertainty in the financial sector as investors (and depositors) try to assess the health of smaller regional and larger money-center banks. In our view, a key issue involves the question of the SVB risk being company-specific (termed idiosyncratic) or industry-wide (termed systemic). We believe the SVB situation included more idiosyncratic risk but also exposed a certain level of systemic risk for the banking industry.

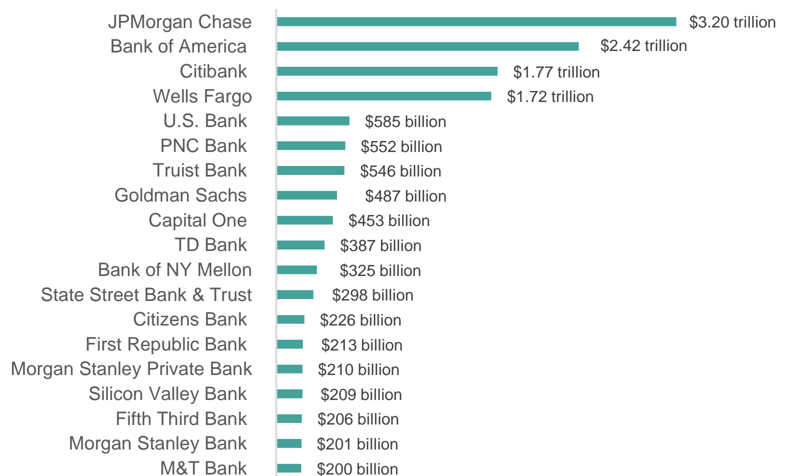
On the idiosyncratic side, SVB's primary customer base of venture capital, IPO, and other start-ups resulted in significant deposit growth between 2019 and 2021. However, deposits dried up with a slowing economy and multi-year lows in capital funding for IPOs and start-ups. With venture capital and next-round funding drying up and thus no new cash for start-ups, deposit growth turned negative as companies burned through cash to fund daily operations. In our opinion, this scenario reflects the company-specific risk that befell SVB and is not necessarily representative of the larger banking industry. The graph at the right illustrates the nation's largest banks based on assets.

However, on the systemic side, SVB (and many other banks) used customer deposits to fund purchases of longer-dated Treasuries and government agency securities, which are considered low risk if held to maturity. It is noteworthy that, as a whole, the banking industry does not appear to be acting "recklessly" with customer deposits by purchasing low-quality securities with exotic features. However, the rapid rise in interest rates induced by the Federal Reserve to help quell inflation has resulted in bonds classified as held to maturity (HTM) being valued at much lower levels than their original purchase price.

Idiosyncratic + systemic = perfect storm. As an industry, while banks have experienced a gradual

Key Takeaways

- Over the weekend, federal regulators moved quickly to guarantee deposits at failed Silicon Valley Bank.
- The new Bank Term Funding Program (BTFP) is designed to provide liquidity for banks during times of stress.
- In our view, the idiosyncratic risk associated with SVB may not result in a systemic risk event for the larger banking industry.



Source: The New York Times, The Federal Reserve, and American Enterprise Investment Services Inc.

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rise in customer deposits, they do not typically experience a short-term doubling of customer deposits. Furthermore, they also do not typically experience significant outflows due to a high proportion of customers involved in cash-burning start-up companies. When combined with the larger industry issue of owning longer-dated government securities in a rising interest rate environment, combined with a loss of confidence (a key factor) that resulted in a "bank run," appear to have been the 'perfect storm' for SVB.

The banking industry is based on confidence, and client confidence eroded rapidly following SVB's announced (after the close on 3/08) balance sheet restructuring and planned capital raise. Media reports have indicated several prominent figures in the venture capital and private equity industries (i.e., SVB's clients) advised their start-up investments to withdraw deposits from the bank. We believe the fluidity of the situation and the declining pace of SVB's deposit base due to the downturn in the "innovation economy" contributed to the bank's inability to find a potential buyer and ultimately caused regulators to step in.

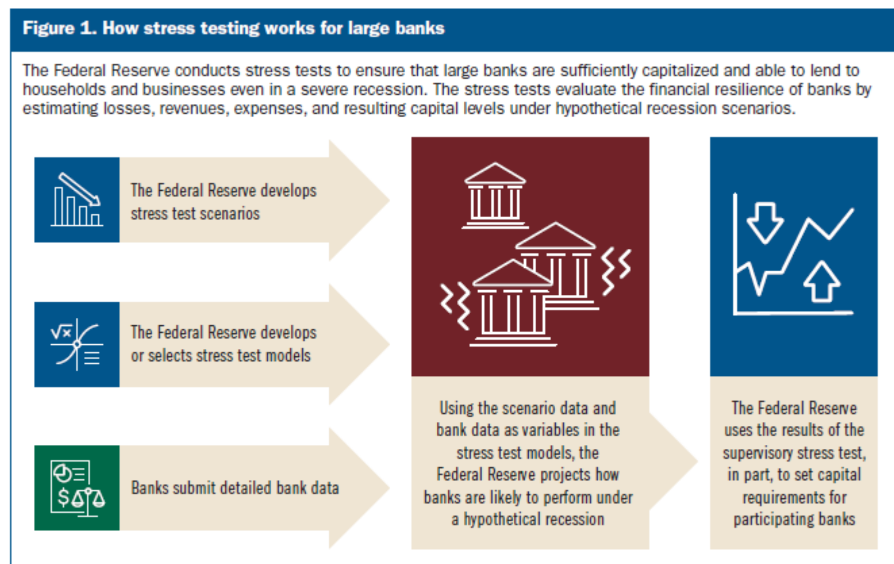
On Sunday evening (03/12), the Federal Reserve announced a new funding mechanism (the Bank Term Funding Program) to help safeguard deposits at eligible depository institutions. Essentially, the new program is designed to let banks move their longer-dated Treasury and agency bonds (held on the balance sheet with unrealized losses) to the Fed in exchange for a 1-year loan valuing the securities at par. By valuing a bank's Treasury and agency securities at par, this new program is designed to stave off selling the securities at a loss and negatively impacting overall capital requirements.

Smaller regional banks were especially hard hit over the past few trading days as investors assess how these institutions can maintain their customer deposits. While the Fed's new Bank Term Funding Program (BTFP) is designed to provide liquidity in times of stress, there remains uncertainty regarding how small, narrowly focused (end markets or customer base) institutions maintain deposits regardless of the Fed's backstop. While the 'perfect storm' for SVB resulted in an FDIC takeover, we do not believe this metastasizes into an industry-wide systemic problem, as we view the larger domestic banking system as well-capitalized.

Assessing the Aftermath

On 03/13, The Federal Reserve announced plans to review its supervision and regulation of SVB. The post-mortem review will be publicly disclosed and is expected to be released by 05/01/23. Vice Chair for Supervision Michael S. Barr stated, "*We need to have humility, and conduct a careful and thorough review of how we supervised and regulated this firm and what we should learn from this experience.*"

We believe the Fed's hindsight analysis could spur regulatory changes for regional banks. In our opinion, the Fed could potentially broaden its definition of a systemically important financial institution (SIFI) beyond just asset levels to include specific industries or geographic markets. The SIFI designation requires a higher level of supervisory oversight, including the annual stress test for the nation's largest banks. The infographic at the right, sourced from the Federal Reserve, illustrates how the stress testing process works.



In 2018, "*The Economic Growth, Regulatory Relief, and Consumer Protection Act*" raised the systemically important asset threshold to $250 billion from $50 billion under 2010's Dodd-Frank. We believe the bank failures could spur Congress to revisit this legislation, which was passed with bipartisan support. Although the annual stress test is a hypothetical scenario analysis, regulators often focus on current economic and lending risks. The results of the stress test help determine the individual capital requirements for all large banks and raise potential warning signs for investors.

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In our view, in addition to increased stress testing, the Fed could consider requiring regional banks to raise additional capital (both debt and equity) to strengthen their liquidity and ability to absorb potential losses. Raising regulatory capital requirements is a lengthy process due to rulemaking and comment periods. However, in our opinion, the reduced visibility into future capital requirements could likely spur regional banks to adopt a more prudent approach to capital management in 2023, resulting in a likely slowdown in share repurchases and dividend growth.

Since regulators agreed to cover both insured and uninsured deposits for SVB and Signature Bank (which was closed on 03/12), the FDIC will implement a special assessment on banks to cover potential losses. We believe the high level of uninsured deposits at SVB could raise concerns that the $250,000 coverage for individual accounts should be increased. Recall, Dodd-Frank raised coverage from $100,000 during the Financial Crisis to $250,000. Like the special assessment, the cost of additional insurance coverage would be paid by the nation's banks.

The Near-Term Implications

In our opinion, the deposit outflows following the run on SVB, adversely impacted the 2023 earnings outlook for regional banks. In our view, deposit costs have risen, while deposit balances have likely shifted within the industry, resulting in a weaker outlook for net interest income (NII) than anticipated just weeks ago. Given the deposit flight and economic uncertainty, we believe underwriting standards have tightened, resulting in another headwind for NII. Q1'23 earnings season kicks off on 04/14. In the coming weeks, we anticipate analysts will downwardly revise their earnings outlook for the banking industry, with more significant "haircuts" for the regionals, than the large banks, which have reportedly experienced an inflow of deposits and clients.

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Price/Book: A financial ratio used to compare a company's market share price, as of a certain date, to its book value per share. Book value relates to the accounting value of assets and liabilities in a company's balance sheet. It is generally not a direct reflection of future earnings prospects or hard to value intangibles, such as brand, that could help generate those earnings.

Price/Earnings: An equity valuation multiple calculated by dividing the market share price, as of a certain date, by earnings per share. Trailing P/E uses the share price divided by the past

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four-quarters' earnings per share. Forward P/E uses the share price as of a certain date divided by the consensus estimate of the future four-quarters' EPS.

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Standard Deviation: In statistics, the standard deviation is a measure that is used to quantify the amount of variation or dispersion of a set of data values. The standard deviation statistic is computed using daily price movements from the preceding 12 months.

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