IRONWOOD
INVESTMENT MANAGEMENT, LLC

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The Banking Crisis of 2023

Is My Money Safe?

On March 10, 2023, the California Department of Financial Protection and Innovation announced the closure of Silicon Valley Bank (SVB) and placed the bank under the receivership of the Federal Deposit Insurance Corporation (FDIC). The parent company of SVB, SVB Financial Group, filed for Chapter 11 bankruptcy protection a week later, on March 17. The collapse of SVB, the nation's 16th largest bank and one of the most prominent lenders in the world of technology start-ups, sent shock waves through the banking system. The failure of SVB was followed just two days later by the shuttering of New York's Signature Bank, the nation's 19th largest bank. The quick demise of two of the country's largest financial institutions brought back bad memories of the financial crisis of 2008–09, which plunged the economy into the Great Recession and struck fear in the hearts of bank depositors, who were left worrying if their bank could be the next to fail.

The failure of both SVB and Signature Bank are dramatic examples of the risks inherent in today's banking system. Traditionally, banks have operated by taking in deposits through demand deposit accounts (checking and savings) and loaning the funds to borrowers. The difference between what they pay depositors in interest and the rate they charge on loans, the net interest margin, is an important source of revenue. The system works smoothly as long as the deposit base is stable, and there is a healthy positive spread between short-term and long-term rates. But rapid changes in interest rates can cause difficulties for banks, as there is an inherent mismatch in the duration of liabilities (short-term deposits) and assets (longer-term loans).

In SVB's case, the management was essentially a victim of their own success. As the premier bank for technology companies, they pulled in billions of dollars in deposits from newly public companies that needed a home to park all the cash they received from recent stock offerings (IPOs) and capital raises. As the bank's coffers swelled, it became impossible to put all the money to work via loans, so the company decided to invest in "safe" US Government Bonds. Unfortunately, the rapid rise in interest rates over the past year caused the market value of the bond portfolio to fall below cost. When word spread that SVB had a potential liquidity issue, depositors raced to withdraw their funds, triggering a run on the bank. SVB tried to raise cash by selling bonds and issuing new equity, but the losses on the portfolio quickly exceeded the bank's capital, forcing the regulators to step in and seize control. Fortunately, the US Treasury acted quickly to guarantee all deposits, even those that exceeded the $250,000 FDIC limit on insured deposits, and a broader financial panic was averted.

The failure of Signature Bank had many similarities to that of SVB. It was a relatively new bank, starting up in 2001. It grew rapidly over two decades by specializing in lending to Real Estate in New York City. It ventured into new economy digital banking, starting its own blockchain payments platform. Signature's rapid growth and specialized client base led to a high level of uninsured deposits. When SVB's problems became front page news, depositors of Signature panicked and began pulling money out of their accounts. Signature did not have the liquidity to meet those withdrawals, forcing the FDIC to step in and seize control.

While the travails of SVB and Signature were somewhat unique, what happened to them could happen to just about any bank in the country. Deposits in most bank accounts can be withdrawn on a moment's notice, but loans are usually committed for longer terms. If depositors rush to withdraw their funds—which, in the age of online banking, they can do with a few clicks of a mouse—few banks have the liquidity to meet those demands.

The quick action of government regulators to guarantee all deposits at SVB and Signature, including those in excess of the FDIC insured limit of $250,000, assuaged the fears of depositors and quelled an incipient banking crisis. The financial markets breathed a huge sigh of relief, seeing that an immediate crisis had been averted, but we are not completely out of the woods yet.

Banks are considered to be the proverbial canary in the economic coal mine because they are usually the first to be impacted by stress in the economy. The banking crisis has been contained for now, but there will be future ramifications. Depositors have become hypersensitive to the risks of keeping large uninsured balances at banks and have begun transferring funds to safer investments, such as money market funds and US Treasury bills. Banks concerned for their liquidity have raised funds via brokered deposits and by issuing short-term CDs. The bottom line is that, going forward, banks will have to pay more to attract deposits. And the higher rates they pay will impact bank profitability. Banks will respond by raising rates on loans or simply by issuing fewer of them. In a recent study, Goldman Sachs estimates that every 10% decline in bank profitability reduces lending by 2%.

The combination of higher interest rates on loans and a tighter credit market will ultimately impact economic activity. Goldman estimates that the expected decline in lending will reduce economic output by 0.3 to 0.5 percentage points this year. The US economy has proven to be remarkably resilient, expanding in the face of rising rates, but as the headwinds to growth continue to build, a downturn becomes more likely.

Should the economy experience a recession, then the next shoe could drop for banks, as businesses may not have the wherewithal to stay current on their loan payments. Banks would have to account for these problem loans, taking charges that would further reduce profitability and adversely impact book values. Fortunately, bank balance sheets are in much better shape than they were in 2008–09. What's more, banks are much more heavily regulated today than during that time.

As the rapid increase in short-term interest rates brought about by the Federal Reserve, ripple through the economy, we expect to see other casualties, notably in businesses that made poor decisions and were left vulnerable to higher rates. Debt levels that were bearable when rates were near zero can become overwhelming at rates exceeding 7% and 8%.

The outlook is not entirely negative, however. There are always opportunities for companies who have made smart businesses decisions. Companies that have large cash reserves and limited debt can often profit despite the financial distress of others. For instance, all the funds that came pouring out of SVB and Signature had to find a home someplace else.

Hopefully, the equity markets have already discounted a lot of this bad news. P/E multiples on estimated 2023 earnings are running at about 18x's, considerably lower than last year, and not far from long-term averages. As always, under circumstances like these, there are stocks with bargain valuations. The average bank stock is selling for a modest multiple of tangible book value with single digit P/E's.

Looking beyond the current challenges, we can see some light at the end of the tunnel. It would appear that the Fed's program of higher rates is having its intended effect. Inflation rates have been declining for nine months. Should that trend continue, as appears increasingly likely, the Fed may soon pause on its path to higher rates.

So, in answer to our opening question—Is my money safe?—we would answer a qualified "Yes." Most banks are on a solid financial footing and appear able to survive the short-term challenges that lie ahead. However, banks should be used as intended, for short-term savings and bill payment. Investors should not keep balances that exceed the FDIC limit of $250,000. Larger sums should be invested in a diversified portfolio of equity and fixed-income securities that are consistent with a comprehensive investment plan.

Sincerely,

Donald Collins | Ravi Jain | Warren J. Isabelle

Attached for your reference is the Ironwood Investment Management, LLC Form ADV Part 2A and Client Relationship Summary. The documents are provided for disclosure purposes only. No action is required on your part.