EVALUESERVE

Whitepaper

US mid-sized banking crisis:

A regulatory and lending decision perspective

Executive Summary

The recent failure of the two mid-sized banks in 2023 was a stark reminder of the importance of overall risk governance, and asset/ liabilities management particularly for banks. Given that one of these banks enjoyed high ESG ratings, it also underscores that focusing on the 'E&S' without giving due weightage to the 'G' is a risker proposition.

The impact might be seen in several areas, including start-up funding, CRE lending, and even the broader technology industry, which is significant, and the specter of bank failure could haunt the decisions of regional banks for months to come. Innovation and related economic growth may get impacted due to the tightening of the availability of capital for start-ups. The collapse of SVB raises concerns about insider shareholding patterns, as the CEO, CFO, and CMO sold shares in the months leading up to the collapse. Although the panic surrounding bank failure appears to have mostly stabilized, regional banks will be feeling the after-effects for months to come.

Several new regulations are expected to impact mid-sized banks, including falling under regulatory assets oversight, lower deposit thresholds, and higher liquidity requirements. Even in Europe, any call for lighter regulations will not get much traction. The pace of corporate mergers and acquisitions in the US may increase, particularly in the technology sector, as start-ups struggle with funding issues. Banking mergers in the US are already occurring to mitigate financial turmoil, and more banks may face liquidity stress and choose to be absorbed by larger institutions or dissolve.

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What Went Wrong

The collapse of Silicon Valley Bank (SVB) and Signature Bank vividly illustrates of the consequences of neglecting risk management efforts, especially in funding, investment, and lending exposures. Banks that do not have a strong governance framework to identify, monitor, control, and report such exposures are generally at higher risk. The risk management program of recently failed banks highlights the importance of effectively managing a wide range of risks, including funding, mismatch, market liquidity, and interest rate risks.

A strong risk management practice in these areas enables banks to profile their deposits and depositors to effectively manage the duration of these liabilities vis-a-vis their investments and lending profile. Both banks had the highest proportions of uninsured deposits across the entire industry at ~90% of total deposits clubbed with the skewed depositors' profile. In the case of SVB, deposits could be withdrawn without notice, but the money would sit in long-term investments, which posed a risk of cash shortages. Furthermore, SVB was compelled to sell their Held to Maturity (HTM) investments, such as treasuries or bonds, prematurely, as they were strapped for cash.

Poorly managed interest rate risk of the bank's investments further increased the problem with very high ratios of 'loans + HTM to total deposits' at ~94% for SVB and ~93% for Signature. The HTM portfolio rapidly started losing value when interest rates moved higher than at the time these investments were made.

Despite the inefficient tracking of the lending portfolio, SVB had been rated high by ESG rating agencies, as the bank managed to attract a significant number of renewable energy companies, i.e. the 'E' aspect of ESG. While tracking a company's environmental performance is becoming easier thanks to data and technology, governance sometimes fails to receive the attention it needs and deserves until stock prices have stagnated or are falling.

The inefficient investment and deposit management led Federal Deposit Insurance Corporation to use the 'Systemic Risk Exception' mechanism to guarantee all deposits of these banks (even those exceeding the $250,000 FDIC limit) as a reactionary measure to avoid putting the entire US banking system at risk

Overall, the failures highlighted the importance of effectively governing various types of risk and the potential consequences of neglecting to do so.

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Impact

The recent banking crisis has impacts on several areas, including capital markets, start-up funding, Commercial Real Estate (CRE) lending, and the broader technology industry. With the worst appearing to be over, banks continued borrowing from the fed, although the average daily borrowing has reduced considerably. Corporations are finding it difficult to raise capital from banks and capital markets, even the CDS for investment-grade companies increased significantly. Furthermore, SVB was aggressive in lending to start-ups, making 15 of their 20 investments since November 2022 in debt financing.

As for equity investment and start-up funding, SVB and Signature Bank were major lenders for US start-ups, and their collapse may cause a cash flow challenge for start-ups in the US. This could lead to postponements of public listings by start-ups, a slowdown of innovation, and related economic growth. The collapse of SVB also raises concerns about insider shareholding patterns. SVB's CEO, CFO, and CMO sold shares in the months leading up to the collapse, indicating a red flag that needs to be tracked while investing in a company.

The impact on CRE lending is also worrying, as lenders may respond to their investors' distress by lending less and scrutinizing more, something that had already been happening for a few months due to rising interest rates, inflation, and property vacancies. Regional banks usually have good exposure to the real estate of their region, e.g. SVB had 15% of loan origination attached to mortgages and Signature had nearly half of its loan backed by CRE. Although the panic surrounding bank failure appears to have mostly stabilized for now, the specter of bank failure could haunt the decisions of regional banks for months to come and will make the debt harder to come by.

Compared to their US counterparts, European banks tend to have a more diversified deposit base. There are no significant concentrations of depositors in any one area due to which European banks may be better positioned to weather future economic challenges.

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What's to come

Increase in Regulatory Oversight:

It is expected that more regulations can be imposed on mid-sized banks. Firstly, mid-sized banks will fall under the regulatory assets oversight of the Central Bank. The 2018 partial rollback of the Dodd-Frank Act provision increased the asset threshold of systemically important banks from $50 billion to $250 billion. The original act could have prevented these failures as both SVB ($200 billion) and Signature ($100 billion) fall in that range. Among other requirements, the Liquidity Coverage Ratio of the act mandates banks to hold a significantly higher proportion of their assets compared to cash outflows in a 30-day stress environment.

Additionally, the FDIC may decrease the deposits threshold to cover under the FDIC Insurance Limit from the current levels of US$250,000 to US$100,000 for mid-sized banks. FDIC has also given an 'opt-out' for smaller banks to exclude any losses or gains on AFS (available for sale) assets from their Core Tier 1 calculations. This may change and smaller banks may be required to show such losses in their CT1 ratios. Lastly, the Federal Reserve may ask mid-sized banks to keep a high proportion of their liquidity, including income customer deposits, in cash with the central bank. This will limit the potential for bond losses and leave the banks in a stronger liquidity position to deal with future deposit outflows. These regulations are expected to have a significant impact on mid-sized banks.

More Banking Mergers in the US:

We have already seen several significant events occur to mitigate the financial turmoil resulting from the banking crisis. UBS and Credit Suisse Group agreed to merge for approximately $3 billion, which marks the largest bank merger of systematically important financial institutions since the 2007-08 Global Financial Crisis. Meanwhile, a subsidiary of New York Community Bancorp, Inc. agreed to take over deposits of Signature Bridge Bank from the FDIC, with Flagstar Bank absorbing 40 of Signature Bridge Bank's branches. First Republic Bank received funding offers from the Fed and JP Morgan Chase, including $70 billion in unused liquidity and a $30 billion joint rescue by 11 large banks. In the UK, HSBC acquired SVB's arm for $1, while regulators struggled to find a buyer for the parent SVB. A group of SVB's creditors formed to potentially profit from the sale of the institution's nonbank assets if a bankruptcy filing is made. As more banks may face liquidity stress by replicating SVB's asset-liability model, they may choose to be absorbed by larger institutions, partner with more liquid institutions to create a more robust entity or consortium or dissolve.

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Conclusion

In conclusion, the recent crisis in mid-sized US banks has shown the importance of effective risk management for banks while managing their deposit and lending portfolios. The impact of the collapse has been significant across numerous areas of banking, and it may take time for these areas to recover. CRE lending may slow down due to the high exposure of regional banks to real estate in their respective regions. It is imperative that the need for mid-sized banks to prepare for falling under regulatory assets oversight, lower deposit thresholds, and higher liquidity requirements. Banking mergers in the US are already occurring to mitigate financial turmoil, and more banks may face liquidity stress and choose to be absorbed by larger institutions or dissolve.

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How Evalueserve Can Help

With over 10 years of domain experience, Evalueserve is a leader in the transformation of banking operations. Clients across the entire corporate and commercial banking value chain were able to find solutions to a multitude of challenges with our help through our focus on digitalization, process re-engineering, insightful customer analytics, operational flexibility, and customized solutions. We support major banks globally and have delivered significant cost and time savings via our proprietary Lending Automation Suite, including our AI-enabled automated spreading tool, Spreadsmart, which makes the credit approval cycle more efficient. Here's how Evalueserve can help you:

- Financial Spreading: Accelerate credit review with our AI-powered automated financial spreading tool, Spreadsmart. Spreadsmart is a web-based platform that replaces manual data entry with automated data extraction from financial statements to a configurable template.
- Portfolio Monitoring: Keep track of your portfolios with support across the portfolio monitoring chain, including covenants monitoring and EWT, and preparation of credit memos/ annual reviews.
- Customer Analytics: Gain crucial insights into your existing customer base as well as prospective clients to help you make informed lending decisions with confidence.
- Risk Modelling: Flag and mitigate risks early to avoid the costly consequences of poor risk management.

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