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COMMENTARY

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More Banking Troubles Emerge, but Seem Contained

- Governments and large banks are acting to instill trust in the banking community.
- Banking woes could give the Fed pause.
- Volatility will remain through this Fed rate hike cycle.

Previously we wrote about two California banks that collapsed. Since that commentary, another bank on the East Coast failed. Then a large bank in Switzerland made headlines when a major international investor said they could not invest more in the scandal- ridden bank, which was already reporting heavy financial losses. Finally, all this news gave some people jitters, causing them to take money out of their banks, leading to speculation that more banks would soon be troubled. The government and banking industry understand these issues and are acting swiftly.

The first issue that needed to be solved had to do with the way banks invested their deposits and the way they were allowed to value those assets. Banks typically invest in long- maturity assets, which recently fell in value when long-term bond yields rose. Banks intended to hold these assets to maturity, so they were allowed to price them on their balance sheets at the price they bought them (par value). After all, they are high- quality assets and if they didn't sell them, they would likely get their money back. This is not like the financial crisis when banks were holding mortgage assets that were not performing. Since the failed banks had over concentrated customer bases (start-ups and crypto companies), the banks experienced large outflows of deposits as their clients needed their money at the same time. With no more short-term assets to sell, these banks were forced to sell their long- maturity assets at a loss. This caused bank profits to tumble, and more customers got nervous and took out their deposits, causing a run on these banks.

To solve this problem, the Federal Reserve Board created the Bank Term Funding Program (BTFP), a new short-term lending facility to allow banks to obtain loans from the Federal Reserve for periods up to a year, after posting collateral (long- maturity bonds valued at par). Now, the banks don't have to sell their long- maturity assets at a loss and could get short-term loans from the government to pay for the withdrawals.

The second problem that needed to be solved is that many of these clients at these banks had large deposit balances, well over the $250,000 limit insured by FDIC. The Treasury Department, Federal Reserve, and the Federal Deposit Insurance Company (FDIC) solved this problem by taking joint action to fully guarantee all deposits for the two banks which the FDIC took over (one of the banks was able to liquidate in an orderly manner without government assistance and plans to repay all depositors in full).

The third issue involving the foreign bank was less of a surprise. The bank had well documented financial troubles and scandals. The Swiss National Bank came forward to lend the bank over $50 billion to boost its liquidity. Additionally, being a large bank, it was deemed "too big to fail," requiring it to have robust insolvency plans already in place.

Finally, there was a risk of contagion. Another U.S. bank was rumored to be in financial distress, and this was causing more outflows and liquidity issues we discussed above. Large U.S. banks stepped in to lend the bank $30 billion in deposits to ensure confidence and support in the banking community.

In conclusion, this U.S. bank debacle can be largely attributed to a few banks holding too much concentration risk in their client base, coupled with the Fed tightening financial conditions. The foreign bank issues were already well documented and not a huge surprise for investors. The silver lining in all this could be that the Fed is starting to see some of the cracks in the economy caused by the Fed's tighter financial conditions and may soon pause their rate hikes and even pivot and cut rates later in the year. While inflation is still high, it is slowing. As we continue through this Fed rate hike cycle, we expect more volatility. There will likely be more cracks that appear in the economy, but the banking problems seem contained to a few mismanaged banks. Big banks and governments are willing to ensure trust in the global banking system. As we navigate mixed market signals and growing uncertainty, please continue to work with your financial professional to make sure you are properly diversified to help mitigate market volatility. Also, make sure your portfolio is aligned with your long-term investment objectives.

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