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# Reaching for Yield and Landing in Failure

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Recently, the Federal Deposit Insurance Corporation (FDIC) took control of two banks, SVB Financial Group and Signature Bank, as customers were demanding their deposits back at a faster pace than the banks could return them. This ended what was the second longest stretch without a bank failure on record, at 867 days going back to October 23, 2020. There are many factors that contributed to the collapse of these two banks, but in our view, the root cause can be attributed to the abrupt tightening of Federal Reserve (Fed) policy during the preceding year in the form of rapid interest rate increases.

Banks typically hold a portion of their assets in high-quality instruments such as Treasury obligations and mortgage-backed securities, which are guaranteed by the U.S Government and thus do not carry credit risk. With the Fed flooding the financial system with liquidity and keeping interest rates extremely low in response to the pandemic, most securities purchased by banks in recent years carried low coupon rates. As interest rates have risen sharply, these debt securities have declined in value and created temporary unrealized losses.

It is important to note that these securities are expected to regain their full value if they are held to maturity. Thus the problem is one of timing. This issue is compounded by the fact that depositors now have viable alternatives for their cash in the form of short-dated Treasury Bills that offer attractive interest rates while being risk-free. This caused bank customers to shift their deposits away from banks and into the Treasury market.

This situation has been manageable for the majority of banks; however, banks with two characteristics are showing problems: 1) those that have reached for yield by holding longer-dated and larger securities positions, and 2) those with concentrated depositor accounts that are above the $250,000 threshold for FDIC insurance. As customers became aware of these two issues, they initiated a run on the bank by trying to withdraw all of their deposits at once. As a result, SVB and Signature Bank were both taken over by the FDIC.

The dramatic response by the FDIC and Fed should help calm depositors and restore confidence in the banking system. While the FDIC previously only insured accounts up to $250,000, they announced that ALL depositors of the two banks will be made whole, regardless of the size of the account balance. We believe this effectively implies a government guarantee of all bank deposits in the U.S., at least for the time being. In addition, the Fed announced a one-year secured lending facility, which will enable banks to borrow against their government-guaranteed securities at par value. This provides banks with a way

to raise tremendous amounts of liquidity in a short period of time without having to recognize temporary losses.

Bank runs result in bank failures when capital cannot be raised in a short period of time. Together, the FDIC and Fed have provided a way for banks to stem the deposit flight and mitigate embedded securities losses. Additionally, the recent decline in interest rates that coincided with the two bank defaults has reduced the unrealized losses on all the other banks' balance sheets, providing some small relief.

Despite the fact that the two key risks have been effectively mitigated, bank stocks continue to be volatile. Depositors at all banks are assessing the perceived safety of their cash, potentially transferring funds in excess of $250,000 to the largest U.S. institutions and those that are perceived to be the safest. At the same time, investors began exiting stocks of regional banks fearing their insolvency in some cases, and more broadly reflecting a potentially slower outlook for industry growth. While regional banks will have some added expenses going forward, such as implicit deposit insurance for large accounts, higher overall deposit costs, and possibly regulators requiring more capital, the sharp declines in stock prices for some banks appear irrational.

At Crawford Investment Counsel, our stock selection process is focused identifying high-quality business with conservative financial profiles. Our bank holdings are no exception, as we view the group through a lens that screens for diversified deposit sources, cautious approach to credit risk, and proven management, among other quality characteristics. This approach has served us well as we have avoided stocks like SIVB and SBNY. Although the current environment is highly uncertain, eventually we believe we could uncover opportunity in the face of irrational actions. We will continue to evaluate our bank holdings on an individual basis with a keen eye on managing the overall risk. But for now, we are content with our current holdings, none of which we view as impaired – either operationally or with respect to dividend income.

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