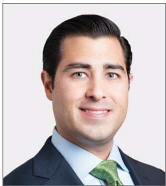
Insights Series | U.S. Banking System

Podcast Transcript



Chris Villalba
Investor Relations

Welcome to Boston Partners Insights going beyond the headlines to provide a deeper perspective on the capital markets. I'm Chris Villalba from Boston Partners Investor Relations Team. On this episode, we check the balance of the U.S. banking system, focusing an investment lens on a sector that touches our lives in many ways, from our weekly paychecks to our monthly mortgages, longer term business interests and more. In late March, Federal Reserve Chairman Jerome Powell stood before reporters to address a shock to the system he oversees.

Jerome Powell: Good afternoon. Our banking system is sound and resilient, with strong capital and liquidity.

C.V. | Silicon Valley Bank, a regional bank with a niche in the tech industry but not really a household name, had gained sudden infamy by failing, sparking wider fears of a crisis in banking. Powell tried to explain what had occurred and how.

J.P. | So at a basic level, Silicon Valley Bank management failed badly. They grew the bank very quickly. They exposed the bank to significant liquidity risk, and interest rate risk; didn't hedge that risk. We now know that supervisors saw these risks and intervened. We know that the public saw all this. We know that SVB experienced an unprecedentedly rapid and massive bank run.

C.V. | His explanation and reassurances were not the end of the story. Two other significant banks would also fail. Signature Bank and then First Republic, which was seized by regulators and quickly sold to JPMorgan. After that dramatic turn, White House Press Secretary Karine Jean-Pierre addressed these epic fails in her May one daily briefing, attempting to put them in context of the great financial crisis of 2008.

Karine Jean-Pierre | The three banks have had unique vulnerabilities and just laid those out. We've seen deposit flows stabilize at regional banks, but we also seen stronger than expected earnings at many banks that include the regional banks. So we see that the process that has been put in place, the tools that have been put in place, has actually been working. This is not 2008. This is a very, very different time.

C.V. | After two plus years that had been among the steadiest in history, the second longest period without a single bank failure in the U.S. 2023 has now endured three of the four largest bank failures ever. And while the system seems to be stable, the historically boring old business of banking is now a hot button topic. Here to deepen our understanding of these events. I'm joined by a member of the Boston Partners investment team whose expertise you can bank on. Equity Analyst Kevin Duggan is one of the top minds at Boston Partners covering the banking industry. He's built his specialty in banking and financial services across a 28 year career, the past 17 at Boston Partners. On this episode of Boston Partners Insights, we take it to the bank in a conversation we recorded in mid-May, about two weeks after First Republic became the largest

bank failure since 2008. We'll look at that event along with the epic fails of 2023 and into the future with an analyst who's covered the ups and downs of the banking system for decades. Kevin Duggan, welcome.

Kevin Duggan
Equity Analyst

K.D. | Good to be here, Chris.

C.V. | I think we should start and give our audience some historical perspective on the banking industry and failures in relation to that. Can you talk a little bit about how large these failures have been relative to history?

K.D. | Yeah, sure. So we've had three large failures so far in 2023. These were three of the four largest in history. Even if you go back all the way to the global financial crisis, these would be number two, number three and number four. The first one was Washington Mutual, which when it failed was about $300 billion in assets. And if you inflation adjusted that to today's dollars, that would be closer to $400 billion. To put that in perspective, First Republic, which failed, had $230 billion in assets. Silicon Valley had $210 billion in assets and Signature Bank had $110 billion in assets.

C.V. | What was the resolution to those bank failures?

K.D. | So ideally, the FDIC would want to have one bank take over a failed institution. So in the case of Silicon Valley, that was assumed by First Citizens and First Citizens is a regional bank that was predominantly based in the Carolinas. Signature Bank was assumed by another New York local bank, New York Community Bank and then First Republic, which was a lot more public, was recently acquired by JPMorgan, which is the only national bank to have participated in any deal so far.

C.V. | You mentioned Silicon Valley Bank. Let's talk about that for a minute. What drove the failure of that bank?

K.D. | So between year end 2019 to year end 2021, so call it two years, Silicon Valley Bank tripled the size of its balance sheet. Their deposit base went from about $60 billion in total to about $190 billion in total. What happened next was that they were flooded with about $130 billion in deposits over that two year period and it could not lend out the money fast enough. So they made a business decision to invest that excess liquidity in securities. And to me, that made total sense.

C.V. | So where did the mistakes begin?

K.D. | Great question. Instead of investing that excess liquidity in shorter dated treasuries and mortgage-backed securities, the company decided to invest the excess liquidity in longer dated securities to get a higher yield. This was mistake number one. To compound that mistake, they elected to not hedge any of the interest rate risk, leaving them very vulnerable to any upward move in interest rates. Mistake number two. Yields on those securities were purchased at very low yields given the Federal Reserve was sitting with the zero bound of interest rates.

C.V. | What came next? You highlighted the mistakes, what the Federal Reserve was doing, obviously that certain things unraveled after that.

K.D. | The environment certainly changed and quite significantly, interest rates went up by 500 basis points by the end of 2022 and they saw the value of those securities that they purchased over that two-year period drop by nearly 20%. At the same time as interest rates were rising, the venture capital funding markets had dried up and Silicon Valley's core customers were beginning to struggle. Given the rapid rise in interest rates and lack of price discovery, funding markets for venture businesses got tight, and in some parts of the market, fund raising was actually closed. Silicon Valley Bank's core customers began drawing down their excess deposits at the bank to fund their underlying businesses. As many of those venture businesses were still unprofitable and were burning cash.

C.V. | I think we should spend a minute or two there. I think it's an important thing that you mentioned that had basically caused them to scramble.

K.D. | Yeah. So as deposits continue to leave the bank, it became very difficult to fund the deposit outflows. Given most of Silicon Valley's liquidity was tied up in those longer duration treasuries and mortgage-backed securities. The unknown risk was that Silicon Valley's over 30,000 corporate clients in activity within them were controlled by a small number of venture capital companies that moved their deposits all in lockstep. And why did that happen? About 90% of Silicon Valley's total deposit base were uninsured. In all of Silicon Valley's customers got spooked. They had a run on their deposits and they essentially became insolvent at that point.

C.V. | You mentioned First Republic as well, which was even bigger than Silicon Valley banking from an asset base. Let's talk about the failure of that company and what drove that.

K.D. | Yes. First of all, First Republic was different, although it had a lot of the same problems that bubbled up at Silicon Valley. Their business model was built upon attracting low earning, large deposit base, but this was predominantly from wealthy customers and not venture backed customers. Silicon Valley Bank took that excess liquidity and they invested it in long-term treasuries and mortgage-backed securities, whereas First Republic took their deposits and they invested them in long duration, low yielding mortgage securities. Similarities between both First Republic and Silicon Valley is they had a pretty similar deposit base in that Silicon Valley had 90% of their deposits that were uninsured, and First Republic had about 70% of the deposits uninsured. They both had very concentrated deposits and they both had affluent customer bases. Given what happened with Silicon Valley in the fear that was in the market of deposit runs, this made First Republic's customers very aware that their deposits may not be safe and they started to pull their deposits as well. To help stave off the run, eleven of the largest banks injected $30 billion into deposits into the company to help plug the deposit hole. But in the end, the velocity of those deposits leaving the franchise was just too much and First Republic ended up failing.

C.V. | Seems like the low interest rate environment created by the Federal Reserve was really the ultimate culprit. Also, mismanagement of risk from the management teams of the bank. But you can always point to a little bit more on the low interest rate.

K.D. | Not only did you go from a low interest rate to a high interest rate, it's the speed at which rates had risen that really caught these two banks offsides.

C.V. | So since we're talking about the Federal Reserve, I think it would be appropriate to talk about regulation. What can be done to change what happened with the banks going forward.

K.D. | So there's a lot of discussions going on currently. And if I would to rank order where I think they're going to shine their lens, higher capital levels — I think this is an absolute certainty that this happens. Banks with greater than $100 billion in assets will have to hold more capital. And at a minimum, they're going to have to hold enough capital to cover the unrealized losses that they're currently carrying on their securities book. It is less likely that banks below the $100 billion in assets will be subject to the same requirements. But at this point, it's unclear where the regulators will draw that line. I would expect a multi-year phase in to get to that endpoint capital level. So I think this is probably a multi-year capital build for the banks. Next, I would say stress testing, the stress testing model has to change. Liquidity stress testing will be definitely be a key part of the stress test going forward. In stress testing for higher interest rates will absolutely be in the test. And I find it somewhat shocking that they haven't tested it yet.

C.V. | Can we focus on stress testing a little bit? Weren't some of the banks not even stress tested? I think it was really only the big major, too-big-to-fail banks that were the most stress tested, obviously. But then there was a group that kind of just flew under the radar, if you want to call it that.

K.D. | Yeah. So there was what they called a tailoring rule. And what that was, is if you were below a certain threshold, you were subject to less soft touch regulation. And one of the key items of that exclusion was unrealized losses on capital. If you

are a bank with greater than $700 billion in assets, those unrealized losses flowed through your capital levels. If you were below that threshold, they did not. So when you optically looking at where capital levels are today, they're inflated relative to the core capital of the franchise. Going forward, regulators will need to account for that.

C.V. | What else do you think will be changing? From a regulatory perspective, you talked about higher capital levels. We just talked about stress testing. There's probably a few more areas that you would like to hit that you think need to change for the industry.

K.D. | I think what really needs to have thoughtful discussion is not to overregulate the banks. We need community banks. They lend to local communities and small businesses. If regulation is too tight, capital requirements are too high. The end result is that lending will not happen within these communities. So I think we have to be very thoughtful to not overregulate these franchises because at the end of the day, those customers and businesses in those small communities need to access capital.

C.V. | What about any changes to deposit assumptions? Do you think that that's going to come down the pipe at some point?

K.D. | I think it needs to be. You know, historically, most deposits were acquired through the branch. And today, as we all know, you can move deposits on your smartphone in the back of a taxicab. So the velocity risk of those deposits moving from one institution to another institution or even to a money market fund is quite high. Silicon Valley lost $42 billion in deposits over the course of a couple of days.

C.V. | Amazing.

K.D. | Which is striking.

C.V. | Let's shift gears and talk about deposit insurance. FDIC, that was something that came up during this whole crisis. Could there be a recalibration of the deposit insurance?

K.D. | There has been talk about it. I do not expect it to happen in the near future. And why is that? Because in order to change the deposit insurance rules, you would need an act of Congress. And given all the headlines we've seen with debt ceiling and all the infighting within Congress, I find that highly unlikely to happen in this environment. One thing to note, 40–45% of the total deposits in the system still remain uninsured. So there's certainly some risk there, over time. A possibility, which I think could happen, is expanding deposit insurance on business transaction accounts would make sense to me. But again, I don't think that happens in the near term.

C.V. | Yeah, it's interesting. I mean, small businesses need to become credit analysts essentially overnight to see if where they keep their deposits to run their businesses are going to be sound.

K.D. | And that's the last thing a business owner wants to do is worry about their deposits when they're just trying to meet payroll.

C.V. | Okay. Let's put our investor hats on now. We did a pretty good job laying out the background of the history of the banks. Which banks were in the headlines. Silicon Valley Bank. First Republic Bank. From an investment standpoint, do you expect the return on equity to be higher or lower through a cycle in these banking stocks?

K.D. | Most certainly lower. At a bare minimum, first thing is you have to carry more capital. And what does that mean – lower returns, but you're safer. On the deposit franchise, I would expect rate paid on deposits will be a headwind for banks for quite some time. The only way to keep deposits in the bank are to have more assurance within the banks is to pay up a little bit more. There's a lot more alternative deposits out in the current interest rate environment, in fact money markets are yielding close to 5%. In all money market assets have just approached $6 trillion in assets, which is an all time high and a striking number. Mix changes, I think people that have no non-interest-bearing deposits are going to move those all into interest bearing accounts and they're only going to leave the bare minimum in their checking account to pay their bills. CDs

is going to be a lot more prominent in the funding mix, as we all know, I've been out looking for some higher yielding CDs and they're most certainly out there.

C.V. | There's certainly more options. What about lending? How's that going to work?

K.D. | I think it slows down. You know, if you're running a bank and you're required to carry more capital, it costs you more to run your business and funding costs. You either charge up on your loans or you lend less. And that's a big worry for me. I don't know specifically where some of that lending could go. JPMorgan is not going to take all of that lending. It's possible that some of that lending ends up in the non-banking system and some of the alternative asset managers step into to fill that void. But I don't think the Federal Reserve and other regulators want that as well, because that's an unregulated part of the banking industry where they can have ownership of that.

C.V. | What about timing? When do you think this is all going to come to fruition?

K.D. | I think this is a multi-year process. I would expect whatever the new capital rules call it, two years, they're effective and then probably a 2–3 year phase. And so it could be upwards of 4–5 years.

C.V. | Shifting gears, what are the implications of a further consolidated regional banking system, including the potential for another big five behind JPMorgan, Wells Fargo, Citibank, etc.?

K.D. | I think it's possible. I don't expect it to happen in the near term. As we've already been discussing, a lot of these banks are carrying large, unrealized losses on their securities books and the way the accounting treatment works for mergers and acquisitions is you have to mark the balance sheet to market. So in other words, they would have to realize the losses on those securities in order to complete a transaction. Given that, I don't think it's likely that it happens in the near term. On top of that, regulation has gotten a lot tighter under the Biden administration when it comes to M&A. Just recently, there was a deal between First Horizon, which is a regional bank based in the southeast of the United States, and TD Bank, and that was pending for 14 months. And it just they weren't able to close it. So the hurdle to get over, to get clearance on a deal is it is much higher than it has been under prior administrations.

C.V. | Do you think that's going to loosen a bit given in light of what's happened?

K.D. | I think it should. I think it will. But what I think needs to happen is I think you need a lower rate environment. You need some of those losses to come off the bank balance sheets. I think the economics of deals need to be more favorable. And then I could see M&A picking up.

C.V. | At what level do you see interest rates becoming more favorable?

K.D. | They're certainly not going back to the zero bound. I would say a couple hundred basis points lower. And I think some of the economics of those deals start to become more favorable. If you're a small regional bank and you're generating a 7% ROE because of all the higher liquidity requirements and capital requirements, you're going to have to get together with somebody else to create those economies of scale to get cost of capital like returns.

C.V. | Kevin, can we put things in perspective for our audience with regard to the number of banks in the U.S. banking industry? Let's go back from 1990, let's say how many banks were there in 1990. Fast forward all the way to today.

K.D. | Yes. So back in 1990, there was about 12,000 banks. And then you flip forward another decade, it went down to about 8,000 banks. By 2012, it was 6,500 banks. And today we're just a little bit over 4,000 banks.

C.V. | Now, is that through a lot of M&A activity within the banks, some bank failures that just didn't rise to headlines? Can you just talk about that a little bit? How did it consolidate from 12,000 in 1990 to just over 4,000 today?

K.D. | Secularly, there's been tons of consolidation in small regional banks. You would see, you know, upwards of 50 banks get together in any given year. Scale matters in banking. We're now in a digital world where scale matters even more.

You need to spread those investments over a larger asset base to make those returned. So I would I would expect to see consolidation going forward.

C.V. | Makes sense. You know, you don't think of there being 12,000 banks in the U.S. To have 12,000 is pretty astonishing.

K.D. | It is, especially when you think of a place like Canada where they're big five banks is about 80% of the entire market.

C.V. | That's a good, interesting point to make. Let's talk about international banks for a minute. Are these a different animal or more of the same? And will the U.S. situation that we have going on today impact overseas?

K.D. | First of all, let's take Credit Suisse out of that conversation. Credit Suisse has been a franchise that has been under tremendous pressure for the last three years or so. They've had outsized losses, litigation scandals, you name it. Putting that aside, given we have just completed the Q1 23 reporting season, you're not seeing the same stresses outside of the U.S. The key things that were pressures in the U.S. — deposits. So far, you've seen only modest attrition in deposits throughout Europe. You've seen no deposit runs throughout the sector. Rate paid on deposits has been increasing, but the levels, especially in Europe, still remain quite low. I am not seeing any stresses currently — so significantly different.

C.V. | Let's move back to size for a minute. Large banks appear to be the safe play, but what about mid and small cap banks? What's the bull case? What's the bear case?

K.D. | So specifically on the large cap banks, we hit on a lot of the points already. They're clearly net winners given they already have ample scale. They have the losses on the securities books is already in capital. They get much higher. Their stress testing is a lot more robust. Their deposit base is much more diverse. Their funding base is more diverse. They already have more short term debt and long term debt in their funding stack. They have a lower share of uninsured deposits. So they check all the boxes of the items that you'd want to look for in a bank in this market. And just given some of the market share to frame that out to your prior question, JPMorgan has about 15% of total US deposit share, Bank of America about 12% in Wells Fargo, about nine. So if you were to add those up, 35% of total U.S. deposit market share is concentrated with three banks. And those happen to be three banks that we like.

C.V. | Okay. Interesting. What about headwinds for smaller, mid-sized regionals?

K.D. | So on the mid-sized regionals, they're going to have to go through that multiyear capital raising strategy. They'll have to raise capital over a multi-year period. Returns of those businesses are going to go down. I believe those are the businesses where you're really going to see them cut back in lending. And they also happen to have more commercial real estate exposure, which is getting a lot of headlines these days. The larger cap banks probably only have mid-teens or so commercial real estate exposure where a lot of the regionals are upwards of greater than 30%. Specifically, office commercial real estate, as we all know – you know, some folks are still working hybrid. They're exiting their space. There's a fair amount of stress in those books currently. Within the banking system, they tend to range from anywhere between 2% of total loans to 10% of total loans – it's probably closer to 2% of total loans for the larger banks. And then some of the mid-sized regionals are probably a tick or two higher than that. So call it in that 3 to 5% range.

C.V. | That doesn't seem very significant. Two to 3 to 5, I guess, depending on the size of the bank.

K.D. | Yeah, but if you're having 50% losses on some of these books, we certainly have steered our holdings away from banks that have outsized commercial real estate exposure in the office space. Some regional banks can have upwards of 10% of their total loans within those books.

C.V. | Interesting. I know when I go into the office, the trains on Mondays are empty and the trains on Fridays are empty. So it seems like it's definitely a three day workweek that we're dealing with now. Are the survivors of this necessarily going to be the big winners?

K.D. | Not necessarily. I think returns on most banks and more specifically, the midsize and regional banks are going to be

structurally lower over time. Consolidation is inevitable. But like we were talking about before, I think it's going to take a few years for that to kind of play out. Who are the big players once all the consolidation happens? I would put that into the remains to be seen bucket. And one thing I would note, I would not rule out some of the big tech companies entering the banking system. So, you know, a lot of banks will talk about their competitors of being Bank of America and JPMorgan and Wells Fargo, but watch out for Apple and Google and Facebook.

C.V. | Yeah, you can open a savings account with Apple now and get a little over 4% yield.

K.D. | Yeah.

C.V. | That's it's interesting. I think it makes sense for them, probably their $2.8 trillion companies so they're bigger than most of the banks anyway.

K.D. | Some of the tech companies are already playing on the outskirts of the payments ecosystem, but it would not surprise me over time if they delving a little bit further.

C.V. | So from a three circles perspective, you know, the Boston Partners investment approach, where we're focusing on companies that contain characteristics of attractive valuation, strong business fundamentals and strong business momentum, where are you finding opportunities within the banking sector?

K.D. | So I would say the opportunity set for banks has certainly narrowed, but it certainly has not closed. We're still finding good fundamental businesses with stable momentum and valuation across the sector remains quite cheap. I would say strong momentum is tough to find in the group given all the headwinds though we've spoken about. But if we can find a good fundamental business that's pretty cheap with relatively stable momentum, we think that's a pretty good opportunity in this market. And then again, based on our prior conversation, where does that steer you – it steers you back to the larger banks. I think the earnings headwinds there are lower. The capital build requirements are lower, their net market share gainers and I think they're the banks are going to continue lending through the down cycle. And I think there's not significantly less credit risk at these institutions and their models are a lot more diversified to sustain any stressing and credit.

C.V. | Given the selloff and the lack of confidence in the banking system, are you going to be sifting through some of the wreckage here to find some hidden gems?

K.D. | Sure. Clearly, valuations have come way in and you've had three big failures. There's a few banks out there that are under stress, but I think at some point the last domino is going to fall and there's certainly going to be some opportunity within the space. What's really difficult to get your hands around at this point is the ultimate earnings power of a lot of these regional banks. So they may look optically cheap at six times next year's earnings, but maybe earnings are 25% too high, so they're really trading at eight times earnings. That's still a pretty good deal. But given the momentum here is so negative, we're happy being patient in this group.

C.V. | So ultimately within banking right now, you certainly want to have an active manager that can really pop the hood on a lot of these banks and go deep and understand what really drive their businesses so we can find opportunities for our clients to ultimately win over time.

K.D. | Absolutely.

C.V. | Kevin, thank you for your time today. This has been great and we look forward to picking up at some point, maybe next year to see how things have gone in the banking industry and some of these things have come to fruition.

K.D. | Thanks, Chris. Great to catch up.

C.V. | That was Boston Partners equity analyst Kevin Duggan, sharing the perspective of his decades of experience and deep knowledge of banking. For more investment related content from Boston Partners, check out our Entry Points video series along with other content, all of which can be found on our website: boston-partners.com. You can also stay connected for our latest updates by following Boston Partners on LinkedIn. I'm Chris Villalba. We'll see you next time with more Boston Partners Insights, where we focus our conversation on the consumer.

Christopher Villalba
Investor Relations

Mr. Villalba is a member of the Investor Relations team at Boston Partners and joined the firm in July 2010. In this capacity, his responsibilities include sales and relationship management of Boston Partners products within financial intermediary channels. Prior to joining the firm, Mr. Villalba was a regional private banker with Wells Fargo Bank, N.A. Before that, Mr. Villalba held the role of investment associate at Morgan Stanley in the firm's Global Wealth Management division. He holds a B.B.A. degree in finance from Pace University and FINRA licenses series 7, 66, and 3. Mr. Villalba began his career in the industry in 2007.

Kevin Duggan, CFA
Equity Analyst

Mr. Duggan is an equity analyst with Boston Partners, specializing in banks and financial services sectors of the equity market. He joined the firm in April 2006 from Fidelity Investments where he held several positions, most recently as a complex securities analyst. Prior to that, he was with State Street where he was an accounting manager. Mr. Duggan holds a B.S. degree in business administration from Boston University. He holds the Chartered Financial Analyst® designation. Mr. Duggan began his career in the investment industry in 1995.

Terms and Definitions

M&A: Mergers and acquisitions (M&A) are transactions in which the ownership of companies or their operating units — including all associated assets and liabilities — is transferred to another entity.

ROIC: Return On Invested Capital (ROIC) represents the rate of return a company makes on the cash it invests in its business.

Bull Market: A bull market is the condition of a financial market in which prices are rising or are expected to rise. The term "bull market" is most often used to refer to the stock market but can be applied to anything that is traded, such as bonds, real estate, currencies, and commodities.

Bear Market: A bear market is when a market experiences prolonged price declines. It typically describes a condition in which securities prices fall 20% or more from recent highs amid widespread pessimism and negative investor sentiment.

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