Investment Insight
Banking Crisis Q&A

The failures of Silicon Valley Bank (SVB) and Signature Bank have naturally ignited many questions in the minds of investors, as evidenced by the volatility over the past few weeks. We have sought to answer some of these questions below and provide a perspective from the investment team at Morningstar Wealth. If you have further questions about the current situation or the response of our portfolio managers, please get in touch. In the meantime, we hope you find the following useful.

What makes banks susceptible to deposit runs?

In their simplest form, banks pool savings (bank deposits) and lend these moneys out, earning a profit if the interest they receive from their loans exceeds the interest they pay after operating expenses. The amount banks lend is much larger than the amount of cash on their balance sheets to meet potential withdrawals of deposits. The amount of capital banks need to hold against its lending activities is subject to regulation.

By financing long-term, less liquid loans with liquid short-term deposits, banks perform an important liquidity transformation role in the economy, promoting long-term risk-taking. However, it is this liquidity mismatch—lending long and borrowing short—that is the main source of their fragility, making banks prone to runs (i.e., banks do not carry sufficient cash or securities on hand to meet all potential redemptions). Over time, governments have sought to reduce this risk by guaranteeing bank deposits, up to a limited amount.

While bank runs often have fundamental catalysts, such as the unrealized losses on banks’ long-term assets, the ensuing withdrawals culminating in a panicked run for the exit by depositors have a distinctly psychological component. This is why the policy responses tend to focus on restoring depositor confidence, as shown by recent actions by the FDIC in making sure that even uninsured depositors of SVB and Signature were able to withdraw their capital.

What is happening to banks now? How does Credit Suisse fit into the US regional bank concerns?

What started as a localized banking issue involving two U.S. banks has spread into a crisis of confidence, leading to stress in global financial markets with U.S. and European bank stocks declining by 21.4% and 15.9%, respectively, so far this month. After Silicon Valley Bank and Signature Bank

1 https://www.nber.org/system/files/working_papers/w27815/w27815.pdf

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entered government receivership on March 12\(^1\). First Republic Bank and Credit Suisse, which both had limited direct exposure to the two now-defunct lenders, saw their share prices come under significant pressure last week.

First Republic Bank came into investors’ crosshairs given its above-average share of uninsured depositors (making it more prone to a run on deposits) and liquidity position, leading a consortium of U.S. banks to inject capital in the bank last week in a bid to restore investor confidence. Credit Suisse, in turn, has been the subject of concerns from investors for more than a year, after it suffered significant losses in 2021 related to the bankruptcies of two of its clients, Greensill Capital and Archegos Capital, raising concerns about the firm’s risk management and its plans to return to profitability. Credit Suisse had already been the subject of significant market volatility last year—when social media rumors about its solvency prompted clients in its wealth management business to pull CHF 110.5bn in assets from the bank in Q4 2022. Investor concerns around the bank resurfaced in recent days amid the stress in the wider banking sector, leading to sharp declines in Credit Suisse’s share price and skyrocketing funding costs. When an announcement on March 15 by the Swiss National Bank about a CHF 50bn liquidity backstop did little to calm investors’ nerves, Swiss authorities saw a government-brokered takeover by rival UBS, announced on March 19, as the only option to restore market confidence. UBS will pay $3.25bn for Credit Suisse, a significant discount to last week’s closing market capitalization of $8bn.

Why has the U.S. regional bank selldown spread to other financial markets?

Though the crisis was materially different than the current bank runs with regional banks, the Global Financial Crisis of 2008 demonstrated how the fragility of banks can impact the broader economy and asset prices around the globe. With this episode uppermost in people’s minds, it is somewhat understandable that market participants react strongly to any perceived weakness in the banking sector. However, the strength of this reaction is not always a good guide to the seriousness of the situation.

What are the risks of further contagion and impact on the real economy?

Banks are central to the smooth operation of the economy, so any trouble with banks increases friction and can slow the economic growth. So far, we have seen little evidence of a broader economic impact, but central banks and governments have been quick to step in and provide support. This approach of early and powerful intervention reduces the probability of a wider impact. However, concern about such contagion can itself slow economic growth as consumers and businesses become more cautious. While a decline in sentiment may slow the economy, it is also likely to reduce inflation and may hasten us along the path to more supportive monetary policy.

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While a bursting of the real estate bubble was at the core of the Global Financial Crisis of 2008/09, what are the underlying drivers of this sell off?

The key driver of the sell-off in the U.S. has been the rise in long-term interest rates that has followed the pandemic and accompanied the fight against inflation that central banks waged. Faced with more depositors than borrowers during the pandemic period, banks used their excess capital to buy government bonds and government-backed mortgage bonds. As concerns about inflation grew, the yield on these bonds rose, causing a corresponding fall in price. This fall in price created an unrealized loss on banks' balance sheets. While some banks were forced to recognize this loss, others, typically smaller banks, were not, providing they did not sell the bonds. However, as clients withdrew their deposits, some banks were forced to sell their bond holdings, crystallizing losses that reduced the capital of the bank. As the financial insecurity of these banks became public, more investors withdrew their deposits, exacerbating the situation.

The situation at Credit Suisse in Europe is quite different. Credit Suisse is a large Swiss bank that has significant wealth management and investment banking businesses in addition to its traditional banking operations. Poor risk management within the wealth management and investment banking divisions has led to a series of losses that have undermined confidence in the bank. As a large bank, which is deeply connected to the global financial system, concerns about Credit Suisse have led to a more general loss of confidence.

How does this banking crisis compare to history?

In a world saturated by countless media outlets vying for our attention, it is too easy to ascribe the title "crisis" to every event. The situation at present is far from being a banking crisis. While most banks have suffered losses due to the sharp rise in government bond yields (and the corresponding fall in prices), few are close to breaching their required minimum capital thresholds that would indicate a genuine banking "crisis."

However, we must not be too sanguine. Banks are highly leveraged institutions that derive profits from a perpetual mismatch in the liquidity of their assets (loans) and liabilities (deposits) and, consequently, rely on confidence. A loss of confidence in the sector can prompt a collapse in the bank, as the weaknesses in that liquidity mismatch are realized. In addition, a reduction in the capacity of banks to lend can feed back into the economy causing unemployment, businesses to fail and inflicting further losses on banks.

Therefore, it’s essential that central banks maintain confidence in banks and provide the necessary liquidity support. And it’s encouraging to note that central banks have been very active in their support over the past week—providing considerable support—which significantly reduces the likelihood of a genuine crisis in the banking sector.
Should I be worried about my bank?

The safety of the money you hold at your bank depends not only on the financial security of the bank but also how much money you have saved in your account, where the bank is based and how it is regulated. However, the fact that the Federal Reserve demonstrated its willingness to protect depositors who were uninsured at Silicon Valley Bank indicates that we can often be too pessimistic about the safety of our savings when we consider the situation of an individual bank. Nevertheless, it is normally preferable to spread one’s savings across financial institutions and bank with large, financially secure, well-regulated institutions, even if they are not offering the highest rate of interest.

What does the current banking situation mean for monetary policy?

For the past year, central banks have been focused on reducing the level of inflation while avoiding a recession. Achieving this outcome against a background of heightened geopolitical risk and ongoing disruption from the pandemic is challenging, but the troubles in the banking sector have made the task even more difficult. However, we expect inflation to be uppermost in the minds of policymakers as they determine monetary policy. This idea was supported by the comments of Christine Lagarde (president of the European Central Bank) at a press conference on March 16, which followed the announcement of a further 0.5% increase in interest rates in the euro area, despite concerns around Credit Suisse. We’ll discover how U.S. officials weigh the conflicting concerns around short-term economic concerns and longer-term inflation concerns at the Federal Reserve meeting on March 21 and 22.

How is the Investment team at Morningstar Wealth reacting to this news?

As ever, we are prioritizing research over reaction. In volatile market conditions, it is very easy to be "whipsawed" by acting too quickly with too much confidence. We are very fortunate at Morningstar to have specialist banking analysts, together with members of our investment team, who focus on valuing banks across the globe. Alongside this, we have access to the world’s leading fund managers from whom we can gain insight.

We are using the current situation to understand both the risks and opportunities presented by the loss of confidence we have seen in banks over the past week and the corresponding reactions from central banks and governments. As investors potentially overreact to recent developments, this may provide an unusually good opportunity for long-term investors to buy banks, and we will be surveying the sector closely for mismatches between price and value. However, we often find the best investment opportunities in these situations arise in asset classes that are not directly affected but have suffered sharp falls in prices because of indiscriminate selling. For that reason, our team is also looking beyond the financial sector at other parts of the equity markets.

To fund these purchases, you may see a reduction in the cash and bond investments that have maintained their value or gained in price over the past week.
What do you anticipate will happen next with regional banks or the economy at large?

When thinking about the future, we must remember that a wide range of outcomes is possible. Therefore, we must think probabilistically rather than becoming too committed to a single outcome. In this way, we are less likely to be surprised by the actual outcome and consequently less susceptible to the behavioral mistakes that follow surprises. Following this approach, we believe it’s most likely that banks that have suffered losses will continue to be supported by central banks and depositors will be protected. However, deposit protection is different from shareholder protection and, consequently, bank stocks may fall further as rumors about the stability of individual banks continue to circulate.

Less likely scenarios include the withdrawal of support by central bankers to avoid the "moral hazard" than encourages bankers to take risk in the belief that they will be protected and, at the other end of the scale, the immediate cessation of concerns leading to a sharp upward movement in the price of bank stocks.

While all outcomes are possible, the price of bank stocks appears to indicate that other investors have adopted a more pessimistic view. This typically presents opportunities for long-term investors who are able to look beyond the current market sentiment.

What happens to Morningstar portfolios if a banking crisis does, in fact, develop?

The impact on your portfolio will be determined by the level of risk you have selected to reach your goals. Our more adventurous portfolios, including those that invest solely in company stocks, have the potential to deliver higher returns over the long term, but may produce more negative returns in the short term if the current situation becomes more serious. In contrast, our more cautious portfolios seek to maintain the value of your capital in the short term but deliver lower returns over the longer term.

More specifically, most of our portfolios hold banks and, consequently, we can expect the prices of that part of the portfolio to decline if the current situation worsens. However, the impact of these bank holdings on your portfolio is limited by the high level of diversification in a typical Morningstar portfolio.

This diversification isn’t an accident. Along with deep research into individual asset classes, our investment teams spend a significant amount of time considering the fundamental overlap in each individual position, prioritizing opportunities that are distinct from those already in the portfolio. In the current environment, while financials areas have come under pressure, even our more adventurous portfolios have benefited from positions like communication services, consumer staples, and healthcare, all of which have been sources of strength over the past few weeks.

More broadly, regardless of whether you’ve chosen a more adventurous or cautious portfolio, the teams at Morningstar are focusing on maximizing the return for the level of risk you have chosen over the planned investment horizon.
What should advisors and their clients do?

Today’s developments are almost custom-made to induce panic, causing investors not only to pull deposits but also to capitulate on their investment plans. While the Global Financial Crisis was a very different problem, it is instructive in one regard: Investors who gave up on markets over the 2008 and 2009 period typically suffered far more than those who stayed the course because, while they avoided some of the losses, they didn’t generally benefit from the gains when the market suddenly turned on March 9, 2009. Assuming your financial plan is intact and your portfolios are well-suited to your goals, our advice remains the same as it always is: Stay the course. Market volatility and terrifying headlines are a given, but losses only become real when you sell. Our nearly 100-person investment team is focused entirely on managing portfolios through today’s developments, and we’ll do the hard work for you: evaluating the unfolding banking concerns, surveying the market for opportunity, taking stock of changing fundamentals and adjusting portfolios as appropriate for individual mandates.

As conditions change and our research unfolds, we’ll make it a priority to overcommunicate in these uncertain times. As always, we are grateful that you have chosen to work with Morningstar.

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Based on a proprietary valuation-driven asset-allocation process, our strategies offer investors a range of multi-asset, risk- and outcome-based strategies designed to help meet a variety of goals. Also, our separately managed accounts offer concentrated portfolios of our portfolio managers’ best ideas. We put more than 35 years of investment experience to work in every portfolio we manage to offer you a better investing experience, because your journey matters.

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