Market Briefing

From:	Edward Toy – Risk & Regulatory Consulting, LLC ("RRC") Director, Investment Specialist (edward.toy@riskreg.com)
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Introduction

On Monday, May 1st, prior to the opening of the market, the Fed announced the takeover of First Republic Bank and sale to J.P. Morgan. This was the third major bank failure in the last two months. Market participants continue to focus on other mid-sized banks with similar profiles.

Following a spike in March, market volatility had calmed somewhat, allowing some time to reflect on the news and consider the causes or underlying issues as well as what the longer-term impact may be on the economy, investment markets and U.S. insurer investment portfolios. There has also been new information about the extent of the problems at some institutions. At this point, very little is certain, analysis by Governmental agencies and market participants will continue and the landscape of what we know is likely to change.

The Events and Announcements in March

Monitoring reporting and analysis since the beginning of March, here is what we pulled together. Over a two-week period in March, two large banks – Silicon Valley Bank ("SVB") and Signature Bank ("Signature") – failed. A third, First Republic Bank ("First Republic") only survived for the moment with an injection of $30 billion in deposits from other banks. The failure of SVB and Signature followed within days of the failure of Silvergate Bank which catered to cryptocurrency-related business. Also, one of Europe's largest financial institutions, Credit Suisse, neared collapse, forcing an acquisition by UBS.

SVB and Signature were taken over by the Federal Deposit Insurance Corporation ("FDIC") in the space of few days after the Federal Reserve, FDIC and Treasury Department jointly deemed both to be Systemically Important, requiring the FDIC to make good on all deposits, not just those below $250,000. This was critical as most deposits at those two banks were not FDIC insured due to exceeding the limit. SVB grew dramatically over the last three years, mostly from catering to technology and technology-related growth companies for deposits, including cryptocurrency-related companies. SVB was a regional bank based on its more localized branches but had $200 billion in assets.

SVB was not subject to many of the additional banking stress tests that were put in place in 2008, and the CEO argued in 2018 that it should not be when Congress raised the threshold for more stringent testing from $50 billion to $250 billion in assets. SVB invested significant parts of the cash it received from deposits in longer dated bonds, both Treasuries and Agency Residential Mortgage-Backed Securities ("RMBS"). With the jump in interest rates in 2022, fair market values of assets dropped dramatically. Additionally, as the markets became more volatile in 2022, funding sources for the deposit base, including venture capital funds, dried up. The result was that depositors needed to pull cash from SVB to fund operations. Rumors of withdrawals led to decisions by other depositors to move cash to other larger banks. SVB revealed the extent of those withdrawals on March 8th, but also that they needed to sell assets at a loss to satisfy those withdrawals. That led to a "run-on-the-bank".

Signature had assets of $100 billion with a deposit base that was heavily weighted to commercial real estate developers. Signature also faced significant withdrawals of more than $10 billion in the first quarter of 2023.

First Republic was similar in that it also had a deposit base that was largely not covered by FDIC insurance. Information about withdrawals in March led to a downgrade by rating agencies to a single B level. On April 24th, First Republic revealed that withdrawals had reached over $100 billion (out of a $200 billion deposit base) before receiving the $30 billion in deposits from other banks as a bailout. First Republic has also indicated that it is facing a $5 billion shortfall in the fair market value of its bonds versus carrying value and a $20 billion shortfall in its mortgage loan portfolio. First Republic continued to look for additional assistance including a possible acquisition as its stock price dropped from a high of $145 a share in February to $3 a share by April 28th, precipitating the most recent action.

The problems of these institutions led Moody's to put the entire banking sector on negative outlook on March 14th. These events led common stock of all regional banks to drop. An index of regional bank stocks declined from $65 to $40 and continues to remain in that range.

The situation at Credit Suisse appeared to be unconnected to the situation described above. Credit Suisse announced in early March that it had found material weaknesses in its risk management. With that announcement, its stock price dropped by more than half within days. This ultimately led to the announcement on March 19th that Credit Suisse would be acquired by UBS for less than half of the value of where its stock closed the prior business day, even after an injection of more than $50 billion from the Swiss central bank. The acquisition agreement included additional support of more than $120 billion. In addition, Swiss regulators decided to trigger a provision that eliminated $17 billion in Tier One capital securities. Tier One capital securities, and similar types of securities issued by financial institutions, are considered debt instruments but include a provision allowing regulators to either convert them into equity or eliminate them when financial solvency is a concern. Information that has been more recently disclosed is that Credit Suisse saw withdrawals of more than $120 billion in the fourth quarter of 2022 and another $60 billion in the first quarter of 2023.

What are the underlying issues?

While analysis of the various failures and what lead to the current situation is ongoing and there may be additional revelations to come, there are a few basic drivers that are apparent with some regional banks, and perhaps also some larger ones.

The liabilities of the many of these financial institutions have proven to be very liquid, not just technically as demand deposits, but also subject to additional factors related to customer behaviors. The fact that the deposits exceeded the $250,000 limit for some of the troubled entities for FDIC guarantees has been noted. Another factor is the increased ability for depositors to move their cash quickly through improved technology.

The rise in interest rates in 2022 led to a significant decline in asset values, especially for longer duration investments. Investments that were considered "safe" from any concerns about credit risk were nonetheless subject to interest rate risk. These assets were also the more liquid in the portfolio and their sales resulted in significant realized losses.

There was significant mismatch between the highly liquid liabilities at the three regional banks that have failed and the longer duration assets that declined significantly in fair market value. The combination of highly liquid liabilities and significant duration mismatch with longer-term assets in a rising interest rate environment did not appear to be properly monitored or managed at the institutions.

Can this happen at an insurance company?

An important question that U.S. insurance regulators have been asking since at least March is: Can this happen at an insurance company?

The answer is yes, though based on the the typical structure of liabilities of insurance companies, it is less likely. To the extent that there is risk, it is mainly at Life insurers, though P&C and Health insurers are not immune.

Life insurers have seen significant asset growth in recent years, much of that in more liquid, shorter term annuity products, some with more limited surrender penalties. On the asset side of the balance sheet, up through 2021, insurers were able to argue that they had good liquidity in their invested assets. But that analysis relied in part on the fact that fair market values exceeded carrying values, so there was no penalty to sell. Based on anecdotal data for year-end 2022, looking at just a few companies, the relationship has now flipped because of the significant increase in interest rates in 2022. In many cases, the aggregate fair market values are now less than carrying values. While those invested assets may still be liquid, selling would now result in a realized loss and a hit to surplus.

The profiles of asset liquidity for insurers have also shifted downward for other reasons. In what had been a prolonged low interest rate environment, there was a gradual shift away from the most liquid Government Bonds to more complex Structured Securities, less liquid assets such as Mortgage Loans, and illiquid assets such as some reported on Schedule BA. This shift has resulted in a portfolio that is significantly less liquid than it may have been a few years ago.

Rising rates also introduces additional disintermediation risk, where policyholders of interest-sensitive contracts may leave to get a higher return elsewhere, either through surrenders or by allowing existing policies to mature and not rolling over into a new policy.

There may be also another factor that layers on top of the invested assets themselves. That is, there has been a material increase in assets pledged as collateral in recent years. This increase likely resulted for two reasons. First, Life insurers have increased their borrowings from the Federal Home Loan Banks ("FHLBs") over the years. Borrowings from FHLBs are required to be collateralized. As the fair market values of pledged assets declined, insurers needed to pledge additional assets. Second, the shifting of interest rates, including the inversion of the Treasury yield curve in 2022, also impacted valuations of interest rate derivatives that insurers used as interest rate hedges. This shift led valuations to change, further requiring changes in collateral requirements.

What should regulators focus on?

As this situation continues to evolve, what should insurance regulators be focusing on? What questions should they be asking of their regulated entities?

Some questions are obvious: Do the insurers have deposits in any of the regional banks? Are there holdings of Bonds or Common Stock in regional banks? Expanding beyond that, what is the exposure to Financial Institutions in general? The sector is likely to remain under some pressure, at least as far as earnings are concerned for a while. This will impact stock prices as well credit spreads which will put negative pressure on the value of bonds.

There are also broader questions that relate to the same drivers that impacted SVB, Signature and First Republic. How liquid are the insurer's liabilities? What is the current fair market value versus the carrying value relationship of the portfolio? How well matched are the asset and liability cash flows? How much business is subject to disintermediation risk? Is there a well-documented liquidity policy and how robust is the liquidity stress testing? Does the company have access to contingent liquidity sources?

With the changes in the investment portfolios that have occurred through the low interest rate environment, how well suited are they to the new, higher interest rate environment? One specific example is investments in RMBS. While there may be limited credit risk for these investments, they are highly susceptible to prepayment volatility. As interest rates rise or just stay at levels that are higher than when they were originated, prepayment cash flows will slow. Reports from different asset managers and analysts have indicated that prepayment cash flows are down 50% to 75% since 2021. There are concerns that some additional declines are likely. Another example is investments in Private Funds and Collateral Loans that are reported on Schedule BA. Higher interest rates will have impacted the valuations for Private Funds and likely also the value of assets that support Collateral Loans.

There are also areas for possible, if not likely, contagion risk from weakness in the banking sector, especially regional banks. Regional banks have been the majority lender to commercial real estate. As banks become more conservative in the near term, this is going to impact available funding, at the same time that commercial real estate valuations have softened significantly, vacancy rates are rising, and existing mortgage loans are maturing. Some analyst estimates put the dollar amount of maturing mortgage loans as high as $2 trillion in the next 18 months.

The report of the recent analysis done by banking regulators to assess the causes of failures at SVB and Signature indicated significant failures in risk management. What is the state of risk management tools at insurers and have adjustments been made for the new market environment? What is the sophistication and experience of management concerning investment risk matters? What is the Chief Risk Officer’s reaction to current events? What kind of liquidity stress testing do the insurers do? What were the cash flow testing and/or Own Risk and Solvency Assessment (“ORSA”) results in rising rate/rate spike scenarios? What kinds of interest rate scenarios are being used as assumptions?

Insurers have typically been able to show that they can manage base case and moderately adverse scenarios cash demands from liabilities with cash flows, possibly relying on selling only the most liquid assets. How reliant is the Company on external sources of capital such borrowing to fund operating shortfalls? Are there restrictions on their ability to borrow?

Closing Thoughts

The failure of SVB, Signature, First Republic and Credit Suisse are significant events. Those three bank failures on their own, based on assets under management, are equivalent to all of the bank failures that occurred in 2008. While there appears to have been specific circumstances at those particular institutions, analysis is ongoing on how extensive the underlying issues may be across the entire Financial sector. There are also significant implications for markets and the economy in general. It is too early to say we have seen all of the problems that may be out there.

The various failures and problems in general also need to be considered in the broader context of current markets and the economy. Inflation is declining but still remains high. The Consumer Price Index for March came in at 5.0% for the overall level and 5.6% for the core level. Both of these are still higher than the Federal Reserve’s target of 2%. As a result, the Fed may continue to raise its target range for the Fed Funds rate. Equity and Bond markets, even before recent events, had reached higher levels of volatility. With investors on edge, negative news will cause that volatility to spike.