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ConnText Podcast

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TRANSCRIPT

Examining U.S. Banks with Matt Daly, Head of Conning North America

Conning ConnText is a quarterly podcast that features our firm's view of capital markets, trends and investment strategies for the insurance industry, hosted by Rich Sega, Conning's Global Chief Investment Strategist.

[OPENING MUSIC]

SEGMENT 1 – OPENING

[Rich Sega (RS)]

Welcome to the Conning ConnText podcast for 2023's second quarter.

The barrage of threats to markets this year can be exhausting. As investors, we face pressing questions: How should we think about the many threats we face while keeping an eye out for opportunities?

We're in the midst of a reversal in the major pro-growth trends of the past several decades. We now have global stresses such as super-power conflicts, de-globalization and constricted supply chains, the rise of privacy and content moderation after a long period of the benefits from expanding broadband, a steady migration away from shareholder value management, and stubborn inflation.

How do we find value? How to separate the wheat from the chaff?

Today joining me, Rich Sega, in Conning's Hartford, Conn. offices, is our head of credit research, Matt Daly. We'll take a close look at the profoundly important component of our nation's financial system, our banks, and the impact they've felt from the recent crisis.

[FADE TO MUSIC]

SEGMENT 2 – ECONOMIC/CAPITAL MARKETS OVERVIEW

[RS] (Time stamp – 1:22)

We see mixed signals regarding U.S. growth prospects. Tightening credit standards by banks and a skittish equity market are worrisome signs. Even the recent FOMC minutes (the Federal Open Market Committee) suggest the governors expect a recession later this year. That's something that central bankers never do – forecast a recession. So this may be possibly an indicator for contrarians.

At the same time, there are hopeful signs. Fixed income markets, credit spreads, and a swoon in corporate profits

aren't approaching levels akin to prior recessions. Earnings and equity markets have seen fits and starts, especially in the first part of this year, and will until the FOMC tightening cycle ends. We think that will be soon, that is, at their May meeting, if it hasn't ended already. Still, to date there has been enough tightening to push us possibly into a quarter or two of negative growth.

The U.S. dollar will likely ease a bit but continue to hold in against economies under stress, especially in the UK and continental Europe, as U.S. dollar yields are still quite a bit higher than the sovereign counterparts.

In this environment, high-grade U.S. dollar bonds in the short to middle part of the curve should provide a good opportunity for income and stability. If we have a recession and it is short and mild, look for an earnings recovery in consumer sectors in the early part of next year and, despite recent weakness, opportunities in dollar-based equities and longer-dated bonds.

[FADE TO MUSIC]

SEGMENT 3 – EXAMINING U.S. BANKS WITH MATT DALY

[RS] (2:58)

A key factor in the assessment of growth prospects and recession probabilities is the state of the nation's banks.

Most small and mid-sized banks strive to have a diversified lending book and a stable deposit profile. Silicon Valley Bank (SVB) was a unique regional bank due to its tech sector depositor base and start-up focused lending philosophy. Its exposure to unrealized bond losses, however, is not unique in the industry and that's why contagion is a threat.

Many banks are mismatched long in their portfolios, attempting to achieve margin and yield for depositors, and have they been scorched by the Federal Reserve's rate raising policy. Managing the "duration gap," something insurers are acutely focused on as a matter of course, now has the attention of every banker in the country.

So Matt (Daly], deposit outflows surprised the industry following the SVB news. Things seem to have quieted down some since the coordinated policy response of the Federal Reserve, the FDIC, Treasury, and a consortium of large banks came in, but the potential to disrupt bank lending for commercial real estate and smaller businesses remains. Does disintermediation continue to pose a threat, or do you think things will get back to "normal"?

[Matt Daly (MD)]

Hi Rich, and thanks for having me on the podcast.

The swift and coordinated actions you highlight certainly seem to have been effective in promoting stability in the banking system. Confidence, as you know, is imperative to banks. And the insuring of all deposits of failed banks, the Bank Term Funding Program and improving access to the Fed's discount window has helped restore some of that confidence.

The data and commentary from banks this earnings season has also reinforced the point that there are not broader systemic issues that will result in widespread failures. Thankfully the industry entered this period from a position of strength, including record revenues last year driven by net interest income, historically low loan losses and strong regulatory capital levels. Nonetheless, we expect volatility to persist as banks navigate rising deposit costs and

perhaps more complex and stringent regulatory backdrops.

And the environment has changed. Bank profitability is going to be pressured with more modest revenue and net interest income growth, as loan growth moderates and net interest margins compress due to higher funding costs. We also expect higher loan-loss provisions, driven by concerns within commercial real estate lending and the subprime consumer areas. So things won't return to the "old" normal and this will take more time to play out, but we will find our "new" normal as the cycle progresses.

[RS] (5:41)

Thanks Matt. Some banks have already raised the rates paid on deposits, some to as high as 4½ - 5%. This might stabilize deposits, but what does that do to profitability?

[MD]

So there's a cost to stabilizing deposits and it's going to pressure profitability. Banks are in an environment of increasing price competition for deposits. Our base-case expectations call for continued margin compression due in part to those higher deposit and funding costs. This pressure will be magnified by slower loan growth, higher credit provisions and the need to maintain greater liquidity and capital than previously.

But let's make it clear that this won't affect all banks equally; the regionals and smaller banks, they're more reliant on net interest income and most impacted in the near team. A few large banks have been the beneficiaries of the crisis as deposits flew to them in a bid for safety. We do, however, expect margin expansion for those large banks to continue decelerating with some contraction as the year unfolds.

[RS] (6:44)

There has been much talk lately about deposit protection from the government. So far, protection has been extended under the so-called "systemic risk exception" of the Dodd-Frank bill, but there's talk about institutionalizing that, formally expanding the FDIC limit and extending the protection to a wider range of depositors. Do you think that will happen and, if it does, how might it affect bank credit?

[MD]

It's something that we understand has been under active discussion, including raising the cap from the current $250,000 level to some larger amount. The cap has been raised numerous times over the past decades, most recently following the 2008-2009 financial crisis. It will be challenging to formally institutionalize a higher cap as this requires a Congressional act and there's plenty of other things on Congress' plate right now. Perhaps the implicit backing of all uninsured deposits will be sufficient to avoid an explicit formal expansion of the FDIC limit. This subject is certainly politically divisive, including the perception of being considered a "bail-out" of Wall Street banks by the general public.

Our team believes at a minimum there's going to be a push for more regulation and improved supervision of that regulation. The most impacted are expected to be those banks that are larger than $100 billion in assets, so those would be the category 2, 3 and 4 banks, but not those designated systemically important. They will likely be subject to enhanced capital and liquidity requirements.

Our team expects the larger subset of those - so that would be banks with $250 billion and above of assets - to be subject to even more stringent regulation. Additional capital, enhanced liquidity, stricter regulation, these should be welcome from the perspective of soundness and creditworthiness for the banks. However, this will entail higher costs to comply with regulation and will likely pressure earnings. These factors will probably serve as a catalyst to further the longer-term trend of consolidation in the banking space. Our team believes more consolidation would also prove positive for creditworthiness. We would see larger, well capitalized organizations that are more heavily regulated.

[RS] (9:02)

On that last point Matt – consolidation along with deposit protection and robust capital positions - that improves the safety question. But what about opportunity? That is, in a world of mobile banking, even if money is “safe” from bank failure, will folks be content to leave deposits in an account that’s below the FDIC limit – wherever that limit is - but also below rates paid on term CDs and money market accounts?

[MD]

Deposits are a key funding source for the banking system, and especially important for those smaller banks. This episode with recent bank failures in an acutely higher rate environment with new technology enabling the movement of deposits with a few clicks on an app, it’s accentuated liquidity risk for both bank liquidity planning and the investment community.

It also highlights the need for investors to focus on diversification in a bank’s deposit base - that includes by uninsured relative to insured, by industry (so think about the interconnection within that industry), client type (institutional vs retail), and geography - in a very rigorous manner, and this all needs to be done within the context of liquidity for that bank. As we’ve recently witnessed, uninsured deposits can move so fast, especially when confidence and trust in a bank erodes. Banks are highly levered entities, which can magnify liquidity problems in challenging times.

[RS] (10:29)

Well to wrap it all up Matt, how will this whole episode affect the broader economy? So much of the economy - small business, commercial and industrial lending, commercial real estate lending – they run through local and regional banks.

[MD]

Very true Rich. The smaller and mid-sized banks are meaningful providers of capital across the economy, so our team believes this episode and resulting pressures (including possible regulatory changes) will weigh on growth to some degree.

The tightening of credit lending standards was already well underway prior to the recent banking failures, so this will likely serve to exacerbate that trend. Increased macro uncertainty, deposits removed from the system and concerns about liquidity at the banks, those will further constrict lending standards. We saw some evidence of that in the most recent Beige Book commentary, this is basically a summary of economic conditions. We saw it across pockets of the country, but it wasn’t uniform so the magnitude and velocity of the impact, they’re debatable.

Commercial real estate is a key focal point in the near term and has the attention of market participants. There were already pre-existing concerns related to rising interest rates, the secular change in office market dynamics and a wall of upcoming debt maturities. This is still in its earlier stages but we anticipate commercial real estate will experience more stress over time. Reduced C&I - commercial and industrial lending - is also a real possibility that could exert incremental pressure on corporate earnings, and that's going to require close monitoring.

An interesting offset that could fill some of the bank lending void is the private credit or direct lending markets. These markets have grown tremendously over the past decades and could help pave the way to a smoother outcome for credit availability than otherwise.

SEGMENT 4 – CLOSE

[RS] (12:23)

Thanks Matt. The economy can't thrive without a healthy banking system, and we appreciate your enlightened perspective on it.

There remain many threats to investors' portfolios this year beyond troubled banks. The FOMC's going all-in on inflation-fighting has put a serious jolt into the fixed income markets, driving rates up to 5% from near zero. The effect on the broader economy could crimp the earnings of corporate bond and stock issuers, straining liquidity and raising asset risk. The dysfunctional Congressional battle over the debt ceiling is a threat to market stability and to growth in its own right, now made worse by the bail-out spending needed to calm the banks. And of course, the launch of the 2024 election campaign season will soon dominate the news cycle, with many contenders weighing in with proposals designed to attract attention as much as solve problems.

The current risk picture simply serves to ratify the general sense that uncertainty rules, so risk management is key to navigating markets in 2023 and into '24, as election cycles bring with them headline risks that are tough to predict.

Through it all, some things haven't changed. One thing that surely hasn't changed is the value of prudent asset-liability management disciplines and solid fundamental credit research.

We hope this information is helpful and we always welcome your feedback and questions. You can get messages to us through your relationship manager, your portfolio manager, or send them directly to us at ConnText@Conning.com (that's ConnText w/ 2 Ns).

We at Conning thank you for joining us, and we wish you all a happy and prosperous summer.

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