

# Capital Markets Strategy

Essential insights for the C-Suite



## What to Watch in the Bank Sector?

10 Metrics to Monitor in the Months Ahead

MAY 2023

**“Through loyalty to the past,  
our mind refuses to realize that tomorrow’s joy  
is possible only if today’s makes way for it;  
that each wave owes the beauty of its line  
only to the withdrawal of the preceding one.”**

André Gide, one of France’s greatest 20th Century writers  
and winner of the 1947 Nobel Prize in Literature

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# 10 Bank Sector Metrics to Monitor

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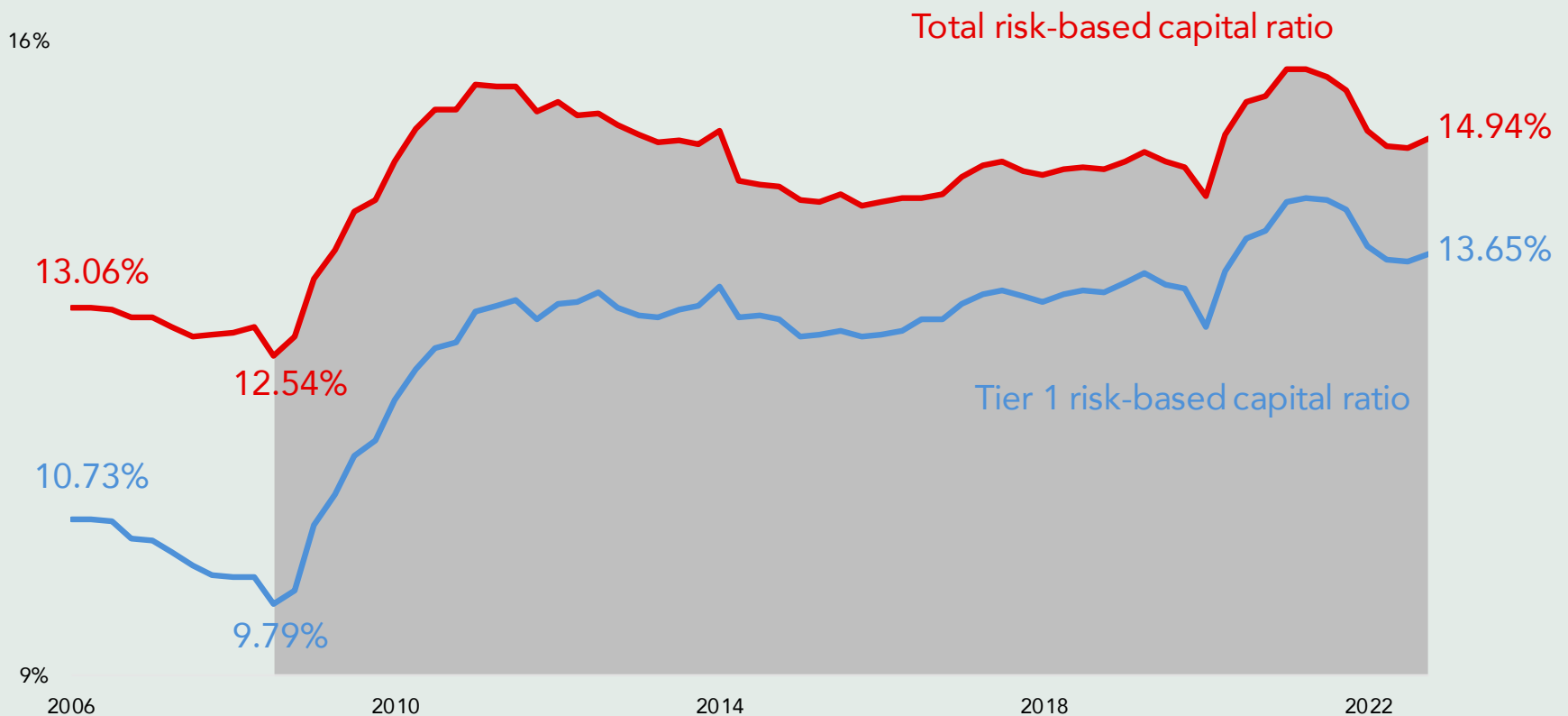


# /. Introduction

# Well Capitalized Banking System

Following the 2008-9 global financial crisis (GFC), banks significantly increased both the quantum and quality of capital they hold. The Fed and other central banks have also provided banks with significant and new sources of liquidity for periods of stress.

## Capital ratios



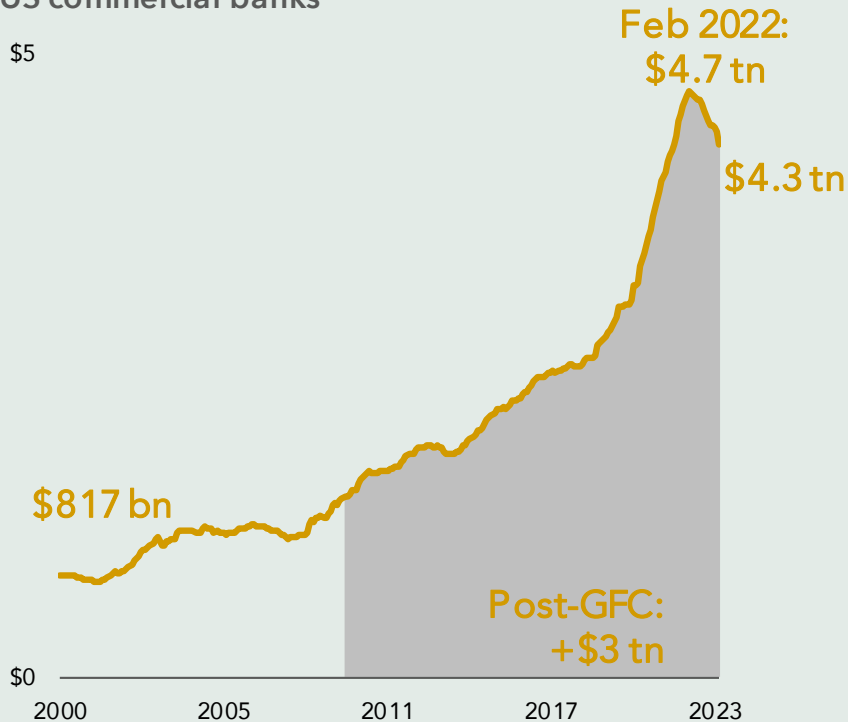
Source: (1) Bloomberg. Data as of May 2, 2023. FDIC.

# Structural Imbalances Creating Challenges

Following a decade of extraordinary QE and “easy money,” financial assets (i.e., stocks, bonds, securities) grew at a much higher rate than GDP, with the US financial system expanding rapidly during a historically low interest rate environment. As that macro regime shifted rapidly post-COVID, numerous large structural imbalances have become a challenge including the size of bank security portfolios, uninsured deposits, and in some cases, business concentration exposures.

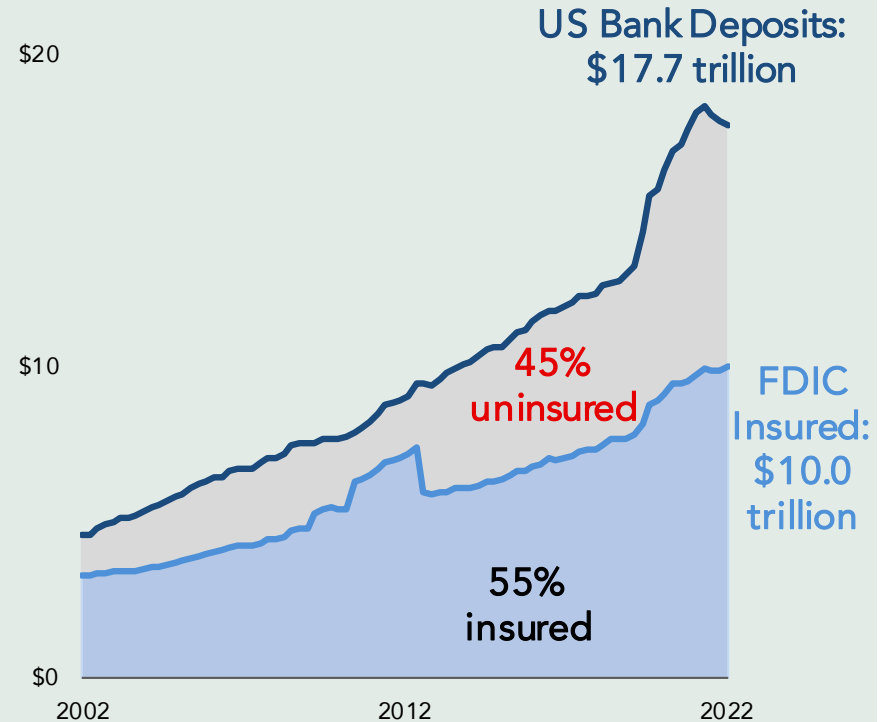
## Large Securities Portfolios

Treasury and agency securities held by all US commercial banks



## Large Uninsured Deposits

US domestic bank deposits, USD tn



Source: (1-2) Federal Reserve. Data as of May 2, 2023. FDIC. Bank Balance Sheet Deposits includes domestic office deposits only. Bloomberg.

# Fed "Double Tightening" Claiming Casualties

Every Fed tightening cycle of the last 40 years has claimed a large financial casualty, and the current cycle has been no different. Even with heightened financial system stress in recent months, the Fed has continued on its "double tightening" path, raising rates again on May 3<sup>rd</sup>, and tapering the size of its balance sheet by \$90 bn per month (QT).

## Fed funds target rate



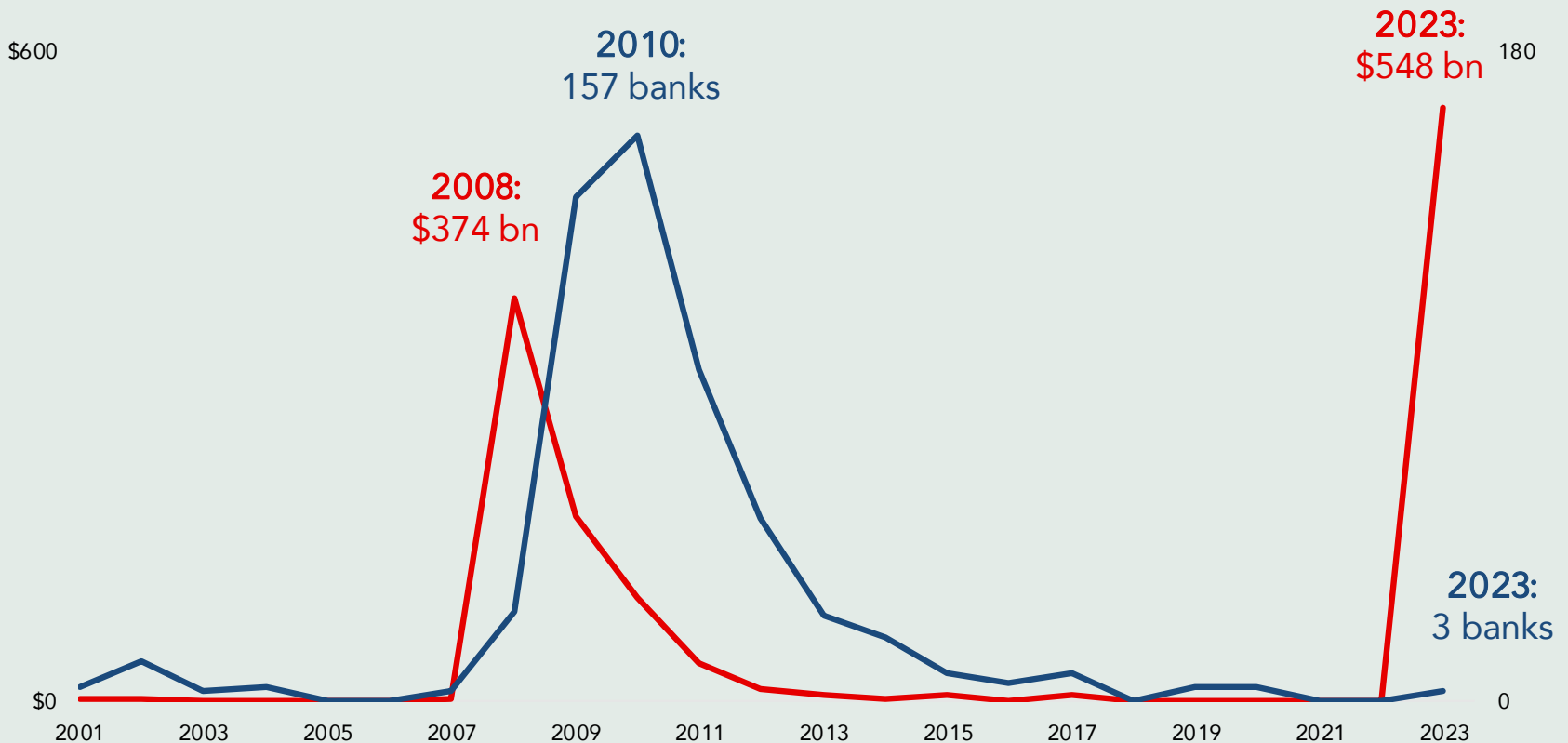
Source: (1) Bloomberg. Data as of May 2, 2023. Oxford Economics, "FOMC Faces a Difficult Decision" (March 20, 2023).



# Fewer But Much Larger Bank Failures in 2023

Since 2001, there have been 564 US bank failures, with a peak of 157 bank failures in 2010, and more than 500 banks between 2008 - 2015. Notably, total assets at the three US bank failures in 2023 (as of May 1st) were larger in aggregate than the 25 banks that failed in 2008 (including on an inflation-adjusted basis).

# of bank failures and total assets (USD bn)

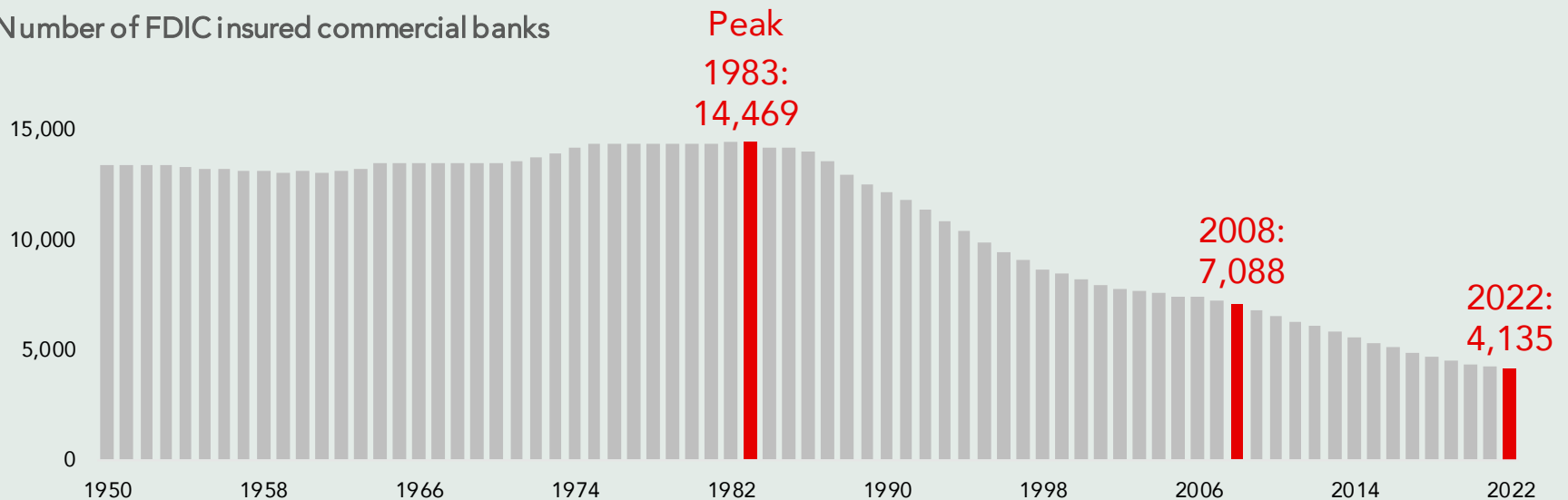


Source: (1) FDIC - Bank Failures in Brief Summary. Through May 1, 2023.

# Further US Bank Sector Consolidation Anticipated

A decades-long consolidation trend in the US banking sector is poised to accelerate in the years ahead as tighter liquidity standards, deposit outflows and a higher cost of capital creates challenges for small bank business models. Forty years ago, there were nearly 15,000 banks in the United States, a number that declined nearly 50% to approximately 7,000 banks before the GFC in 2008, followed by an additional 40% decline closer to 4,000 banks today.

Number of FDIC insured commercial banks



## Expectations for US Bank Sector Consolidation:

- **Near term (1-2 years):** Slow pace expected (regulatory approval and portfolio mark-to-market)
- **Medium term (3-5 years):** Significant pace of consolidation (tighter liquidity standards, deposit outflows and higher cost of capital challenging small bank business models)

Source: (1) FDIC Historical Bank Data. Through year end 2022.

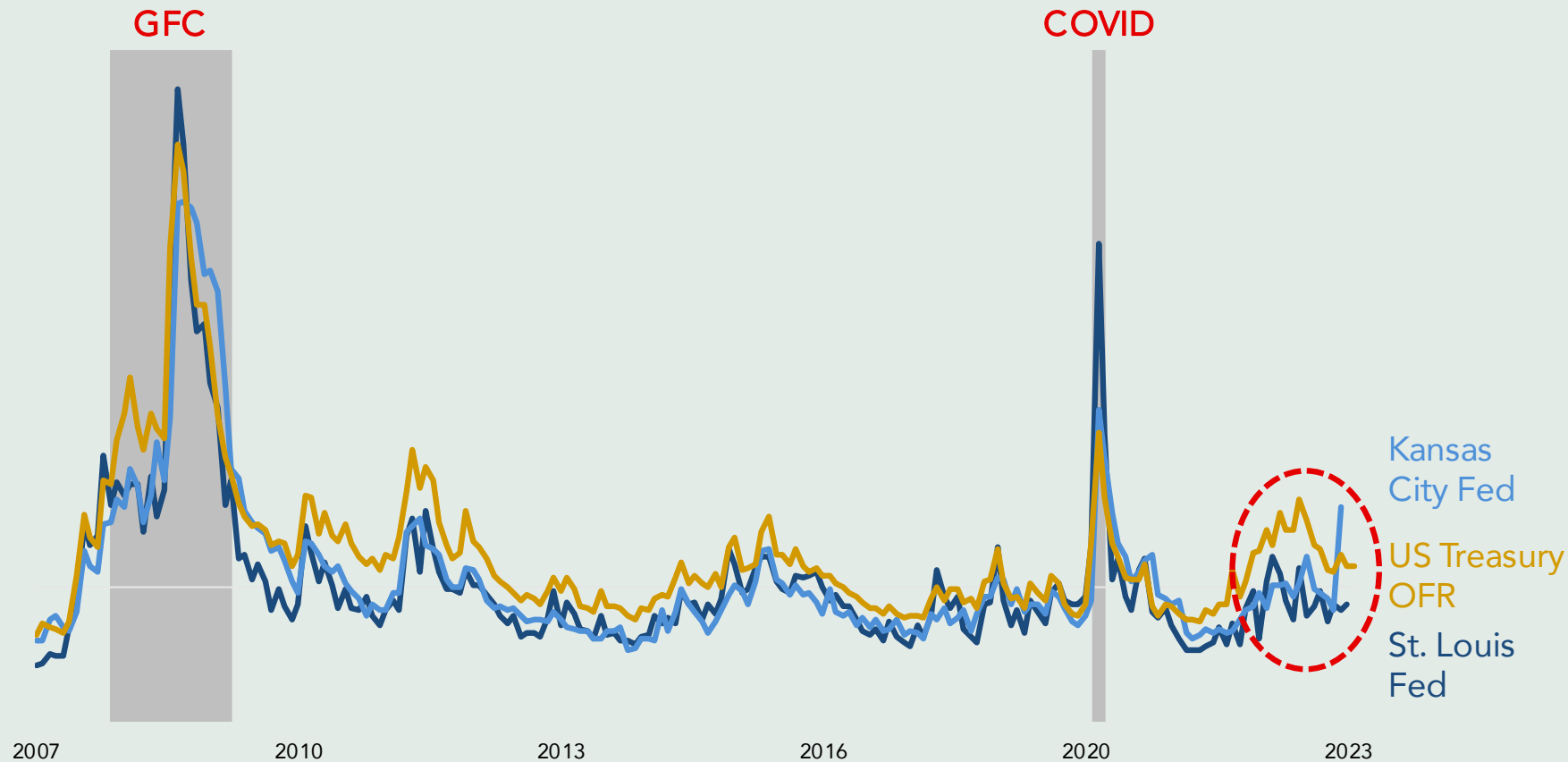


## // 10 Bank Sector Metrics to Monitor

# 1. Fed Financial Stress Indices

Both the Fed and the US Treasury's Office of Financial Research (OFR) produce indices that measure the extent of stress across the US financial system in aggregate. The recent upward movement of these indices provide readings on the systemic impact of Fed tightening and recent bank failures, as well as a read on the effectiveness of the regulatory response in providing liquidity and ensuring efficient resolution where problems arise.

Financial stress indices

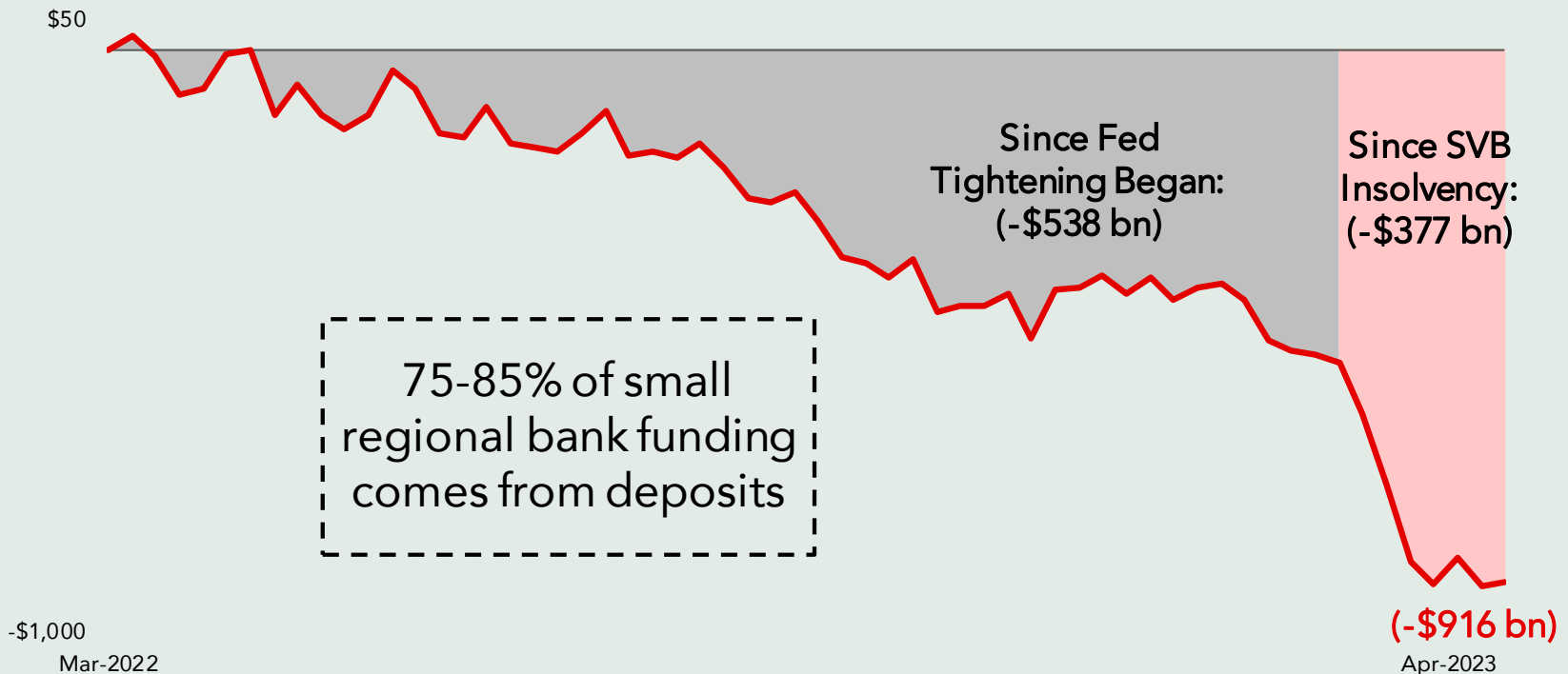


Source: (1) Bloomberg. Data as of May 2, 2023.

## 2. Bank Deposit Outflows

While the preponderance of the 2008 global financial crisis centered around (toxic) assets, liabilities (i.e., deposit outflows) have been the greater challenge recently. The FDIC is permitted to act on a bank-by-bank basis to increase deposit guarantees; however, any wholesale expansion of deposit guarantees for all banks requires a joint resolution from the US Congress, and the signature of the President. Given that approximately 45% of US banking system deposits are uninsured and that small regional banks rely on deposits for an estimated 75-85% of their funding, this is a metric that should be watched closely.

Cumulative change in commercial bank deposits since start of Fed tightening cycle (March 2022), USD bn

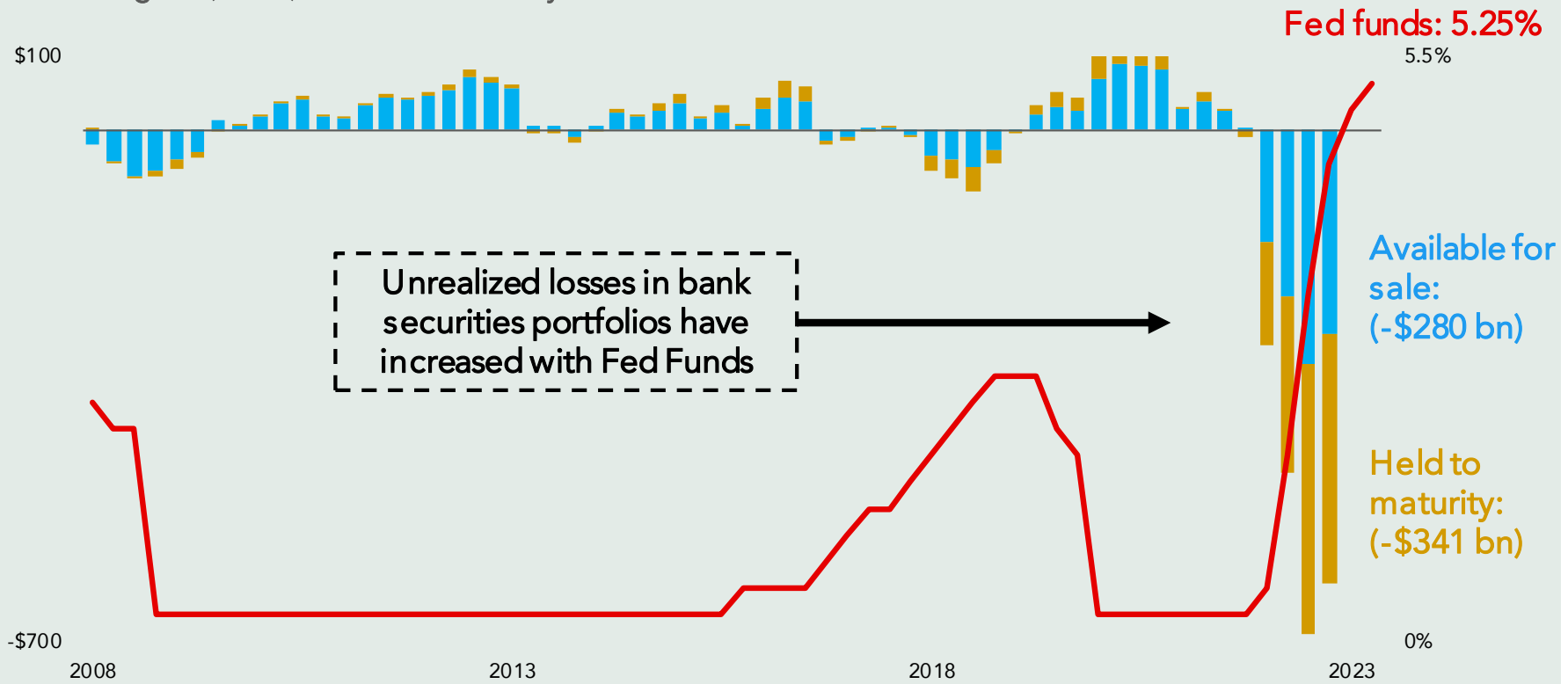


Source: (1) Federal Reserve. Torsten Slok, Apollo. Bloomberg. Data as of May 2, 2023. Seasonally adjusted. Includes both large and small banks.

# 3. Unrealized Losses in Security Portfolios

Over a decade of extraordinary QE where financial assets outpaced GDP growth, banks built large, long-duration securities portfolios. As rates rose and spreads widened, unrealized losses on these portfolios increased from \$8 bn in Q4 2021 to \$620 bn in Q4 2022. At a micro level, where unrealized portfolio losses at a specific bank are significant in size vis-à-vis tangible common equity, the confidence of investors, counterparties and rating agencies may weaken, thereby triggering other events (deposit outflows, short-selling, downgrades, etc.).

Unrealized gains (losses) on securities held by FDIC insured institutions

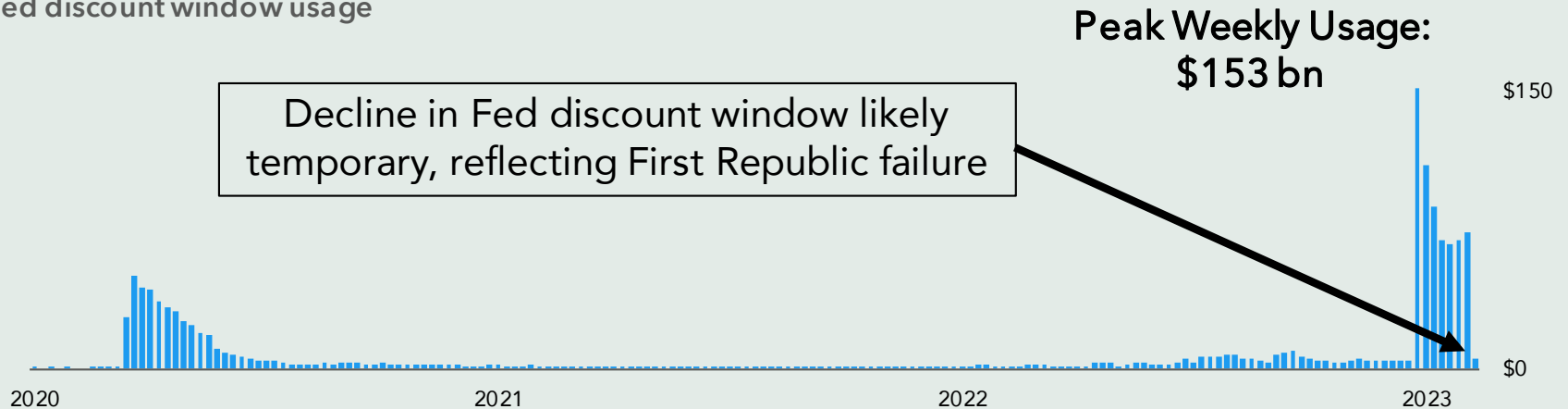


Source: (1) FDIC. Bloomberg. Data as of Q4 2022 (latest available).

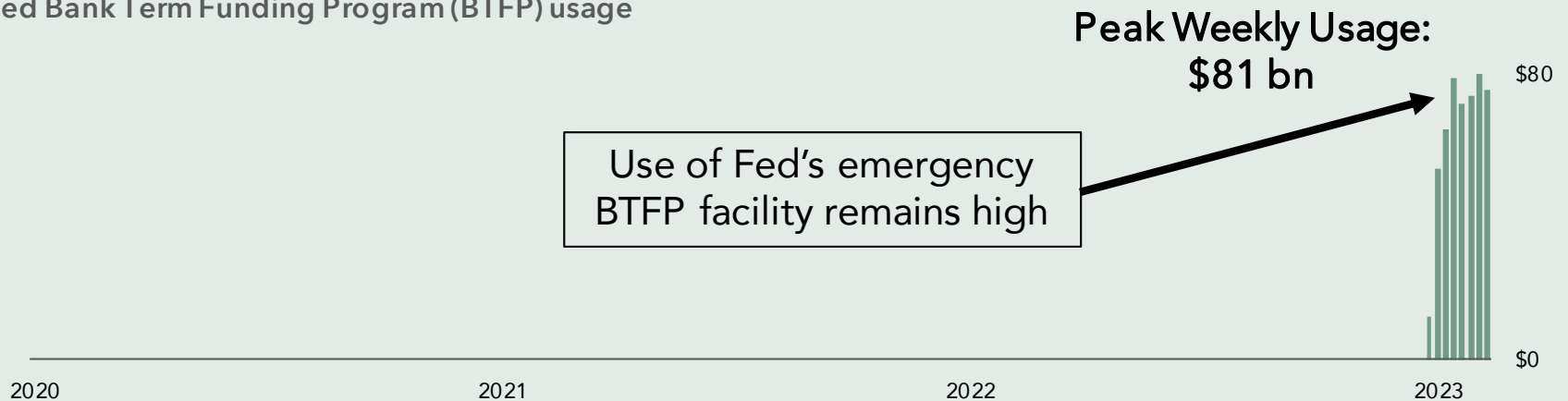
# 4. Use of Fed Liquidity Facilities

As the US bank sector stabilizes, one would expect the use of Fed liquidity facilities (i.e., discount window, new BTFP program) to decline sharply. However, as evidenced by data released each Wednesday, usage of Fed liquidity facilities in recent weeks remains high.

### Fed discount window usage



### Fed Bank Term Funding Program (BTFP) usage

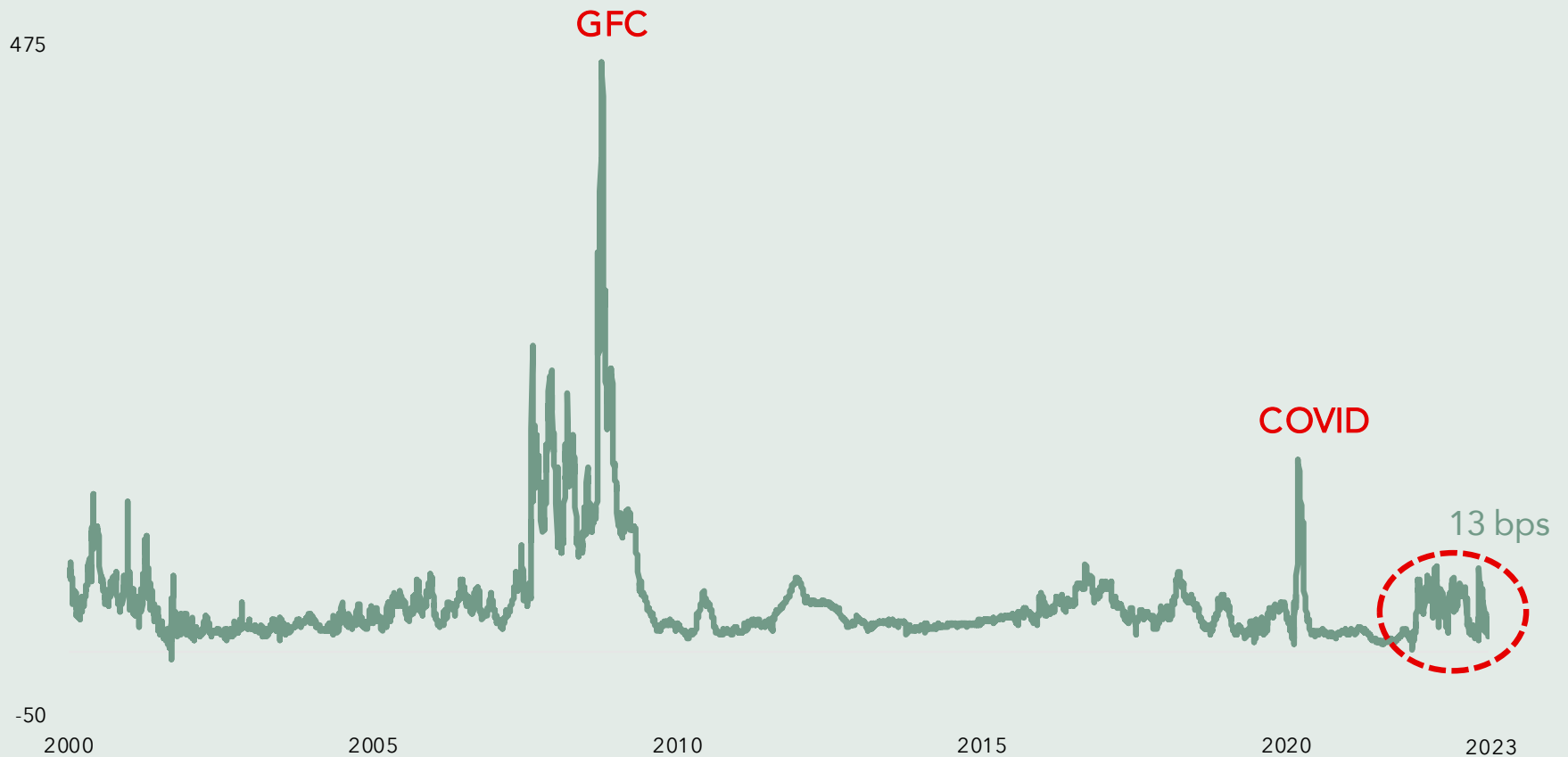


Source: (1-2) Federal Reserve. Bloomberg. Weekly Balance as of latest Wednesday level (May 3, 2023).

# 5. Interbank Lending Markets

The “Ted Spread” (the gap between the rate banks lend to each other (i.e., LIBOR) and the equivalent T-Bill yield) provides an important measure of trust, or confidence, between banks.

TED Spread (3M Libor - 3M US Gov't Yields), bps



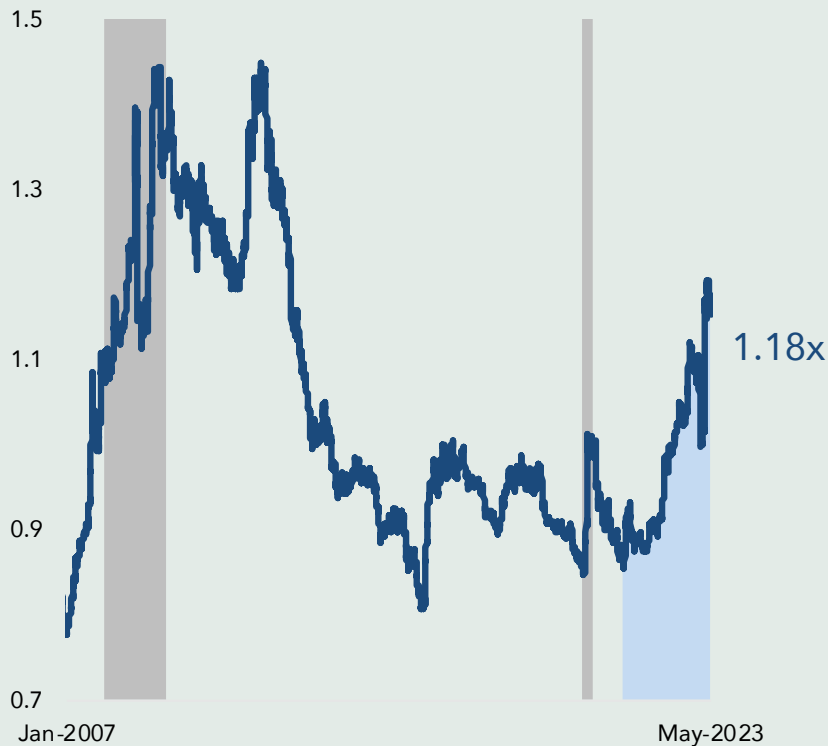
Source: (1) Bloomberg. Data as of May 5, 2023.



# 6. Bank Funding Risk Premium

Historically, financial sector credit spreads diverge from corporate credit spreads during recessions or periods of financial stress. Over the last two months, financial sector IG credit spreads and CDS have traded at a significant premium to non-financials. As MMFs offer an attractive alternative to deposits, and as credit concerns increase as the economy moves closer to recession, the higher cost of capital for banks will be an important metric to watch.

Financial sector / non-financial corporates spreads



US financials CDS spreads

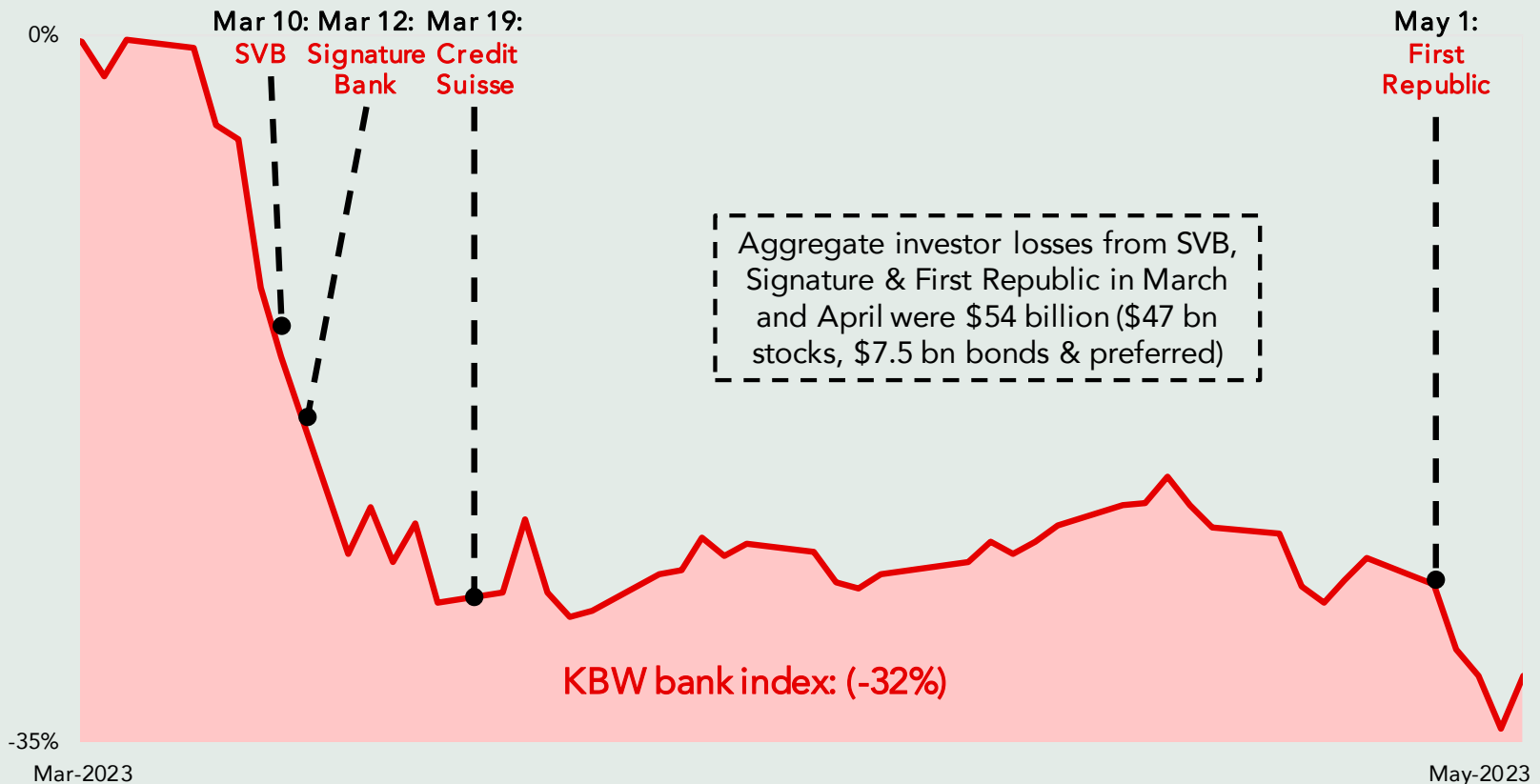


Source: (1-2) Bloomberg. Data as of May5, 2023. Financials is Bloomberg IG finance total return index. Corporates is US corporate bond index. CDS is Markit CDX North America Financial Index.

# 7. Bank Stock Prices

Banking is a confidence business. The KBW Bank Index has therefore become an important barometer for US bank sector sentiment. Since early March, the US regional bank indices have significantly under-performed their global peer group, and have come under renewed pressure since First Republic's failure on May 1.

KBW bank index performance since March 1, 2023

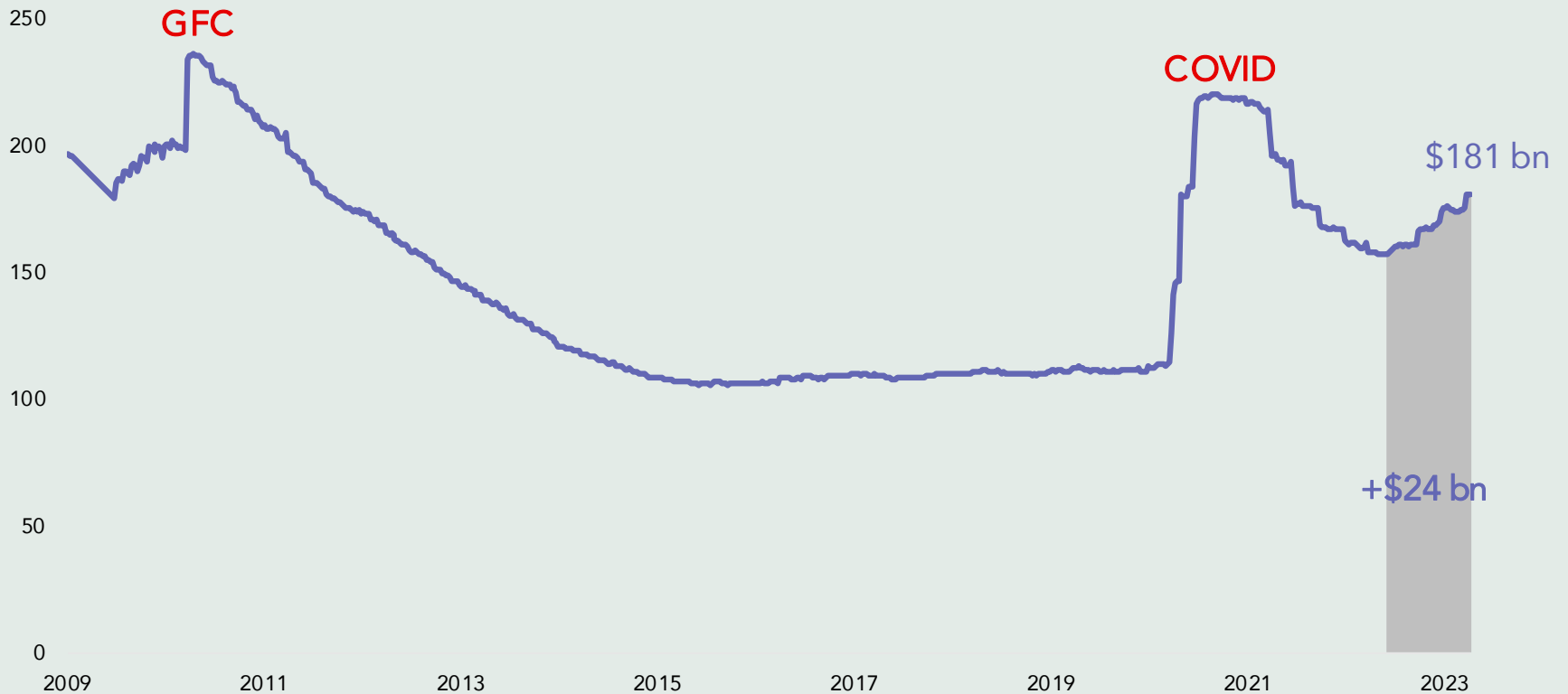


Source: (1) Bloomberg. Data as of May 5, 2023.

# 8. Increases in Loan Loss Provisions

As the Fed continues to tighten policy (rates, QT), the impact of which operates with a significant lag, and macroeconomic conditions worsen, banks are writing off bad debt and setting aside additional reserves at levels approaching that of the COVID crisis three years ago. Recent bank earnings reports show notable increases in loan loss provisions across a broad spectrum of consumer and business lending activity (i.e., credit cards, auto, small business).

US commercial bank assets allowance for loan and lease losses, USD bn



Source: (1) Bloomberg. Data as of May 2, 2023. Federal Reserve.

# 9. Tightening in Bank Lending Conditions

Deposit outflows and higher bank funding costs have implications for bank lending activity, which in turn impact the real economy. In March, the Fed's banking conditions survey showed loan demand declining for the 5th consecutive period, with broad-based contraction across multiple sectors.

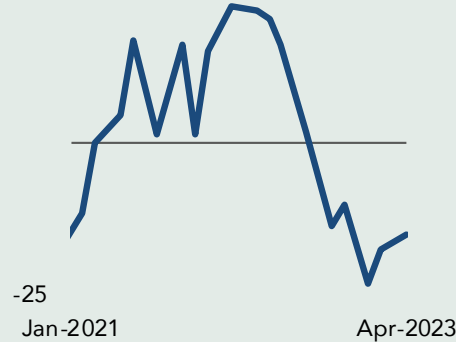
Total bank loan volume index

50



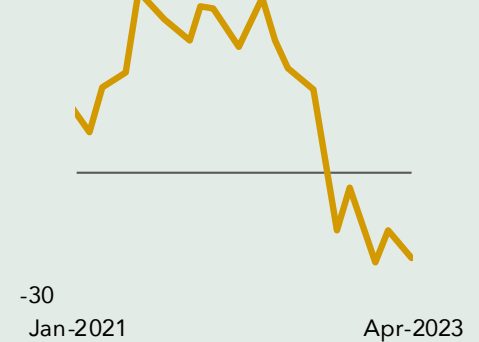
Commercial & industrial loan volume index

25



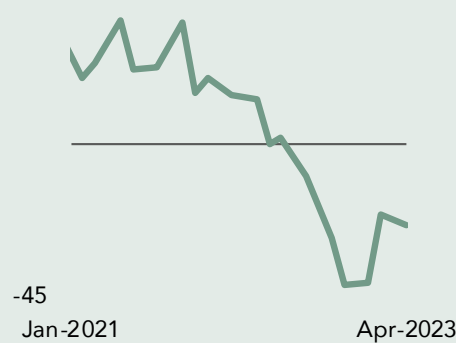
Commercial real estate loan volume index

45



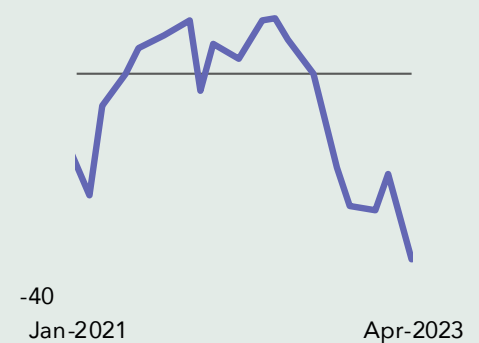
Residential real estate loan volume

45



Consumer loan volume

15



Source: (1-5) Federal Reserve Bank of Dallas. Banking Conditions Survey. Data collected March 21 - 29, and 71 financial institutions responded to the survey.

# 10. Regulatory Policy Changes

The FDIC released a report in early May analyzing options for a sweeping overhaul of its deposit insurance program after multiple recent bank failures reduced the Deposit Insurance Fund (DIF). FDIC Chair Martin Gruenberg highlighted that digitization and growth in uninsured deposits have increased bank run exposure. Today, roughly 45%, or \$7.7 trillion, of US deposits are uninsured.

## Potential changes to the FDIC insurance program

	<i>Status Quo</i>	<i>FDIC Preferred Option</i>	<i>Politically Less Viable</i>
	Limited Coverage	Targeted Coverage	Unlimited Coverage
<b>Description</b>	Current framework (\$250k per account)	Vary coverage by account type	Unlimited coverage
<b>Advantages</b>	<ul style="list-style-type: none"> <li>Well tested</li> <li>Minimum disruption</li> <li>Less moral hazard</li> </ul>	<ul style="list-style-type: none"> <li>Better align with business needs</li> <li>Strengthens financial stability</li> </ul>	<ul style="list-style-type: none"> <li>Minimizes bank runs</li> <li>Strengthens stability</li> <li>Simplifies resolutions</li> </ul>
<b>Disadvantages</b>	<ul style="list-style-type: none"> <li>Greater deposit outflows</li> <li>Higher financial stability risk</li> </ul>	<ul style="list-style-type: none"> <li>More account types</li> <li>More complexity</li> <li>Additional DIF funding required</li> </ul>	<ul style="list-style-type: none"> <li>Higher moral hazard risk</li> <li>Exorbitant increase in DIF funding required</li> </ul>

Less  
Deposit Insurance

More  
Deposit Insurance

Source: FDIC "Options for Deposit Insurance Reform" (May 1, 2023).

# Epilogue: Expectations from Washington



As the US banking crisis has intensified, we believe that pressure is “ramping up” in Washington to expand deposit guarantees, but that major legislative action is neither imminent nor likely near-term

## Who?

**The Senate Banking Committee is the “center of gravity” for any potential action.** The House Financial Services Committee will likely defer to the Senate for leadership if bank sector problems persist.

## When?

**Pressure to act is “ramping up” given duration of bank stress, but still not imminent or likely near-term.** Timing would be post-debt ceiling resolution, and only if bank sector deteriorates substantively from here. Contagion to farming states, agriculture and auto sectors also likely needed.

## How?

FDIC may expand insurance on a bank-by-bank basis (especially for closed banks) as they did for SVB and Signature, but **a broad-based expansion of deposit insurance to all banks requires a joint resolution from Congress** (60 votes in the Senate, 218 in the House), signed by the President.

## What?

If needed, Congress could pass legislation to increase deposit insurance coverage, and expand FDIC/ regulatory powers. Since unlikely near term, **Treasury use of the Exchange Stabilization Fund (ESF) is the more likely vehicle for bank sector support if needed near term** as the FDIC’s Deposit Insurance Fund (DIF) declines. Treasury use of the ESF does not require Congressional approval.

**“The FDIC is permitted to act on a bank by bank basis, particularly in the case of closed banks, to increase insurance deposit guarantees, but any wholesale permanent action would require a joint resolution from lawmakers. Any expansion of the FDIC’s current deposit insurance guarantee framework that reaches all banks wholesale would therefore need to be approved via a joint resolution from Congress, which requires passage in both the House and the Senate, and sign-off by the President.”**

Henrietta Treyz, Managing Partner &  
Director of Economic Policy at Veda Partners

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### Role

Tom Joyce is a Managing Director and Capital Markets Strategist within MUFG's global capital markets and investment banking business. Based in New York, Tom heads a team that creates customized analytical content for multi-national S&P 500 companies. His team provides in depth analysis on the impact of economic, political, public policy and regulatory dynamics on the US credit, foreign exchange, rates and commodities markets.

### Experience

Tom has over 25 years of Investment Banking experience in New York, London, Hong Kong, and San Francisco. Over the last 15 years, Tom created and built the Capital Markets Strategy role, advising corporate C-Suite executives (Boards, CEOs, CFOs, and Treasurers) on the pervasive macro forces driving markets. Tom also presents at dozens of corporate events each year including Board meetings, CEO ExCo sessions, CFO and Treasury off-sites, corporate leadership events and conferences.

### Education

Tom's educational background includes a year of study at Oxford University from 1991 - 1992, a Bachelor of Arts in Political Science from Holy Cross College in 1993, and a MBA from Kellogg Business School, Northwestern University in 2000.

### Personal

Tom resides in New Canaan, CT with his wife and four sons, where he serves on the Board of Trustees of the New Canaan Library as well as the Holy Cross College President's Council.



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### Experience

Hailey has over a decade of Wall Street experience, including three years as a Consumer Sector Specialist in Equity Sales and nine years as a Capital Markets Strategist. Hailey is also a member of MUFG's Inclusion & Diversity Council and has devoted years to participating in and developing Wall Street recruiting programs.

### Education

Hailey graduated with honors from the University of Michigan's Ross School of Business with a BBA and a minor in International Studies.

### Personal

In March 2020, Crain's New York Business Magazine named Hailey one of the "Rising Stars in Banking and Finance".



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### Experience

Stephanie has spent over five years as a Capital Markets Strategist. She is an active member of the University of Michigan recruiting team and is focused on the diversity recruiting effort at MUFG. Stephanie is also a part of MUFG's DEI, Culture & Philanthropy (DCP) Council.

### Education

Stephanie graduated with honors from the University of Michigan's Ross School of Business with a BBA.

### Personal

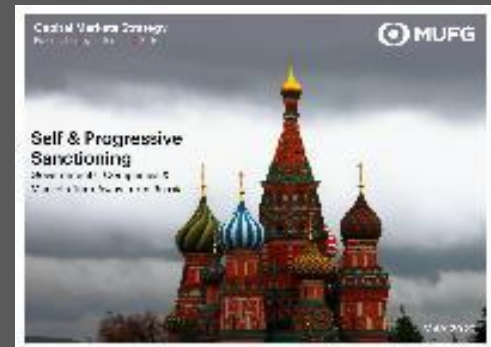
Stephanie is actively involved in NYC's iMentor program, mentoring high school students with their journey to college graduation.

# MUFG's Capital Markets Strategy Team





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