

Overview of recent events affecting the banking sector

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An increasing level of trepidation has taken hold in the global capital markets, with no corner unscathed and risk assets bearing the brunt. Things started to unravel last week when Silicon Valley Bank (SVB) suffered a failed financing effort that triggered concerns about whether it had enough assets to cover its deposits. As the weekend came to a close, regulators stepped in to insure SVB's deposits and then those of Signature Bank, and both institutions found themselves out of business. They are the second- and third-largest bank failures, respectively, in U.S. history.

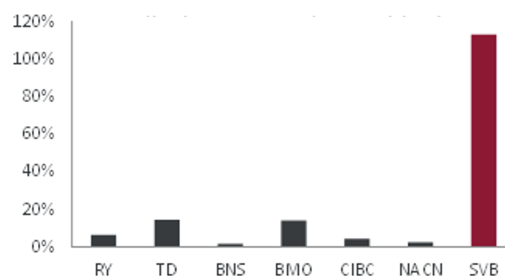
The strong action undertaken by the regulators to protect investors and provide liquidity to the banks calmed the markets briefly, despite growing scrutiny of bank assets, their risk controls (SVB seemingly had none) and a spate of rating agency downgrades for U.S. regional banks. Things came further unglued by mid-week, however, when the largest shareholder of Credit Suisse said it would not provide additional financial support, sending market worries to a new high because Credit Suisse is classified as a global systemically important bank (G-SIB). In other words, it is a lot bigger than SVB and has a much larger reach. Eventually, the Swiss National Bank (SNB) said it would provide liquidity to Credit Suisse as necessary.

OUR TAKEAWAYS

Canadian banks deserve a more nuanced look

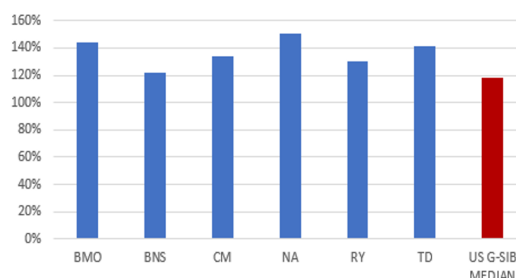
From the Canadian perspective, we note that our domestic banks are very well capitalized. If anything, they are viewed globally as a relative safe haven in the financials space, with strong deposit bases and top-notch regulatory oversight, just as they were during the global financial crisis. A review of unrealized losses on debt securities as a proportion of CET1 (see below for the definition) for Canadian banks versus SVB shows this strength, as does the liquidity coverage ratio of each of the Big Six compared with the median of the G-SIBs in the United States.

Unrealized Losses on Debt Securities / CET1



Source: Company reports, CIBC Capital Markets

Liquidity Coverage Ratio for Canadian Banks



Source: Company reports, S&P Global Ratings, S&P Cap IQ Pro., et RBC Capital Markets

Regulators have sprung into action

Credit Suisse and the US regional banks now face acute funding pressures and liquidity risks, despite the recent support offered to Credit Suisse by the SNB. US regulators are combing through the books of all the country's regional banks and are planning to report on their status in a couple of weeks.

Premature parallels are being drawn

Even though comparisons are being made to the financial crisis of 2008, we think such pronouncements are decidedly premature. SVB operated in the tech space without a chief risk officer for almost a year, Signature Bank was exposed to the heightened vagaries of the crypto market and Credit Suisse has been unravelling for some time.

Nonetheless, the dramatic valuation decline of fixed income securities in 2022 and questions about their classification on balance sheets – as held-to-maturity, trading or available-for-sale – are creating sustained unease amongst regulators, rating agencies and investors alike. Attention will now turn to broad-based scrutiny of bank balance sheets. Any exposure of institutional investors and investment banks to entities deemed undercapitalized will extend, and perhaps deepen, the market's concern. Should the situation be contained to a few US regional banks and the SNB's support for Credit Suisse, the markets will most likely chug ahead. Further problems may emerge, however, if the violent asset price declines under way trigger additional stress in the system. Ironically, the associated boon in the bond market is relieving some of the fixed income valuation concerns that precipitated the tumult. We are also likely to witness a tightening of credit conditions more broadly in the United States, as regional banks partially address liquidity issues through their lending books.

Unregulated shadow banking poses risks

As we close the chapter on the stresses currently facing the regulated banking system, it is worth reminding ourselves about the risks posed by the unregulated shadow banking industry (see definition below) that has been booming ever since the Great Financial Crisis. With the regulations put in place under the Dodd-Frank Act a decade ago, higher-risk loans and complex products moved to the "alternative" banking industry, which is a gentler term for shadow banking. The trillions of dollars scooped up by modern shadow banks does not have the same government oversight or backstop in the event that stresses emerge. We have begun to see some cracks in their ability to raise funding for new flagship products and a faster pace of markdowns across a wide swath of asset classes, including real estate and private credit. Central banks have not paid much attention to this segment of the market, but we expect the SVB and Credit Suisse surprises to wake them from their slumber.

Finally, we think close attention will be paid to regulators and their willingness to step in and avoid broader and deeper problems, reinvigorating ongoing concerns about moral hazard.

CONCLUSION

We are closely monitoring the situation in all risk asset markets and are scouring them for attractive valuation

opportunities in both equities and credit, especially because investors have a habit of initially divesting high-quality, liquid assets (namely the only things they can sell) in times of trouble. Volatility will continue to be the name of the game for the foreseeable future, creating recurring opportunities to take advantage of valuation fluctuations.

DEFINITIONS

CET1: A crucial regulatory bank ratio is the common equity tier 1 ratio (CET1). The ratio is composed of tier 1, or core, capital, which consists primarily of common stock and retained earnings. Tier 1 capital is then divided by the bank's total risk-weighted assets, taking into consideration the risk of each asset. Canadian banks' CET1 (13.7%) exceeds that of US money centre banks (11.7%), demonstrating that they are managed more conservatively.

Liquidity coverage ratio (LCR): This ratio is often defined as a metric that aims to ensure a financial institution has an adequate stock of unencumbered, high-quality liquid assets (HOLA) that can be converted into cash at little or no loss of value to meet its liquidity needs for a 30-calendar-day liquidity stress scenario. The LCR is a key gauge to ensure that a bank has sufficient liquidity. Canadian banks are well above the minimum requirement of 100% specified by the Office of the Superintendent of Financial Institutions (OSFI), with ratios ranging from 122% (BNS) to 151% (NA). US G-SIBs have lower LCRs, ranging from 106% (State Street Corp) to 136% (Morgan Stanley). Hence, Canadian domestic systemically important banks (D-SIBs) have more liquid assets to cover deposit withdrawals than their US counterparts do. We expect banks will focus on improving this ratio in the coming quarters to solidify their liquidity capacities. US regional banks, including SVB, were not subject to this requirement.

Shadow banking: This broad term is used to describe bank-like activities that take place outside the regulated banking sector. The traditional players in shadow banking are bond funds, money market funds, specialty finance companies and now alternative asset managers. Their primary activity tends to be lending on bespoke terms to borrowers of all types, although in recent years deposit gathering has taken on a more prominent role. A defining trait of shadow banking is its relatively unregulated nature, which offers far more flexibility for market participants in relation to regulated financial institutions.

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ROOTED IN HISTORY, INNOVATING FOR THE FUTURE.

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