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Bank Failures Stir Investor Concerns

On the heels of the collapse of cryptocurrency exchange FTX earlier this year, three banks, two headquartered in California and one in New York, all of which relied heavily on deposits tied to the cryptocurrency industry, are being liquidated or taken over by Federal regulators in the past week. Silvergate Bank, headquartered in La Jolla, CA, announced on March 8th that it would wind down its operations after suffering a significant outflow of deposits. It was followed by Silicon Valley Bank (SVB), the 16th largest bank in the country, which was taken over by regulators on March 10th after it, too, suffered large and fast outflows of deposits. SVB is a major lender to Silicon Valley venture capital funds and startups. SVB's numerous tech-related depositors, have seen a significant financial downturn over the past year and have needed to utilize funds on deposit for operations. As depositors withdrew funds, SVB needed to liquidate significant fixed income assets it held that have been devalued in the recent, rising, interest rate environment. An attempt to raise cash through the sale of bonds at a loss of $1.8 billion just days after Silvergate failed caused a run on its deposits. With insufficient liquidity, regulators took over SVB.

Closer to home, Federal regulators seized control of New York regional Signature Bank over the weekend. Like Silvergate and SVB, Signature had courted cryptocurrency clients. In trying to raise cash for nervous depositors, each of these institutions could be adversely impacted as the value of their underlying, fixed rate investments dropped due to a rapid rise in interest rates over the last year. It was reported that SVB sold over $20 billion of its bond holdings last week to provide cash for its investors but in doing so lost over $1.8 billion. SVB became the largest bank in the US to fail since 2008 when Washington Mutual succumbed during the financial crisis. Signature now becomes the third largest bank to ever fail in the US.

This current crisis, triggered in large part by volatility in the cryptocurrency market, differs markedly from the 2008 fiscal crisis which had its roots in mortgage failures. The present dilemma is significantly smaller and much more "localized" to a handful of banks while the 2008 debacle deeply impacted most of the largest banks and financial institutions in the country. The reaction to today's problem is also being addressed differently by the White House and US Treasury Department. In an interview yesterday, Treasury Secretary Yellen emphasized that the situation was much different from the financial crisis almost 15 years ago, which led to bank bailouts to protect the industry. "We're not going to do that again," she said. "But we are concerned about depositors, and we're focused on trying to meet their needs."

Funds deposited at banks in the US are protected by the Federal Deposit Insurance Corporation (FDIC) which guarantees up to $250,000 per individual account. Public entities, i.e., counties, towns, villages and school districts, are further protected by investment rules that require that their funds be collateralized, typically by Treasury securities held by a third-party custodian at ~1.02%. In an effort to avoid a domino effect among other banks weakened by this crisis, earlier today the Biden Administration announced that all deposits held at the three banks will be backed by the Federal government.

Bank stocks have taken a hit over the past couple of days to varying degrees. The Fed's quick actions over the weekend were intended to provide significant support and comfort. Though some have questioned whether recent events might harken to more widespread bank failures similar to 2008, when Washington Mutual closed, it is important to note that significant regulations have since been put into place resulting in greater capitalization and ability to meet stress tests. As of this writing, First Republic Bank in New York and Western Alliance Bank in California have seen dramatic drops in their stock prices.

In order to quell the markets and protect depositors, the FDIC established a "bridge" successor bank on Sunday so that SVB and Signature customers can access funds starting today. The FDIC announced it will fully protect all depositors and financial institutions associated with the banks without limit. In addition, the Federal Reserve is creating a new Bank Term Funding Program to make available additional bank funding to help assure that banks have the ability to meet depositor needs.

Market watchers believe that the failure of the three banks could impact the actions of the Fed's Open Market Committee which is scheduled to meet later this month. It has been reported that economists at Goldman Sachs alerted their clients last night that the firm now expects the Fed won't raise rates at its next policy meeting on March 22. Also, tax exempt rates are expected to decline in the near term as investors' "flight to quality" sees funds move out of banks and the equities market and into Treasury securities and municipal bonds driving those rates down and perhaps opening a window for refinancing opportunities.

Municipal investors need to remember that their rule for investing public funds is: *security first, liquidity second and yield third.* CMA believes that the current problem affects liquidity much more than security. The next few days should provide a clearer picture of how the markets will be impacted in both the short and long term by these dramatic developments. Capital markets don't react well to uncertainty and these are uncertain times where cool heads will be needed to weather this storm.

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