Key Questions

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Is the Banking Industry Facing Another Liquidity Crisis?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

While some banks are facing significant funding pressures, we do not think this is the beginning of a large-scale liquidity crisis.

Bank stocks have recently been experiencing a rocky ride, to say the very least. One bank that is well known for its involvement within the crypto ecosystem announced that it would be "winding down operations and voluntarily liquidating the bank." This followed the failure of FTX and spurred a run on the bank's deposits, which then forced the bank to sell assets at significant losses, and ultimately resulted in the bank's collapse.

Another bank with a focus on venture capital technology clients announced that it was restructuring its existing AFS (available for sale) portfolio and raising $2.25 billion in equity, following a larger than expected decline in deposits. This restructuring from a longer duration portfolio to a shorter duration portfolio was performed so the bank could enhance its liquidity position. However, this came at a huge cost – its stock plummeted over 60% on the news, rattling the markets. In the end, this bank also succumbed to collapse.

Finally, this news has led to an increasingly poor sentiment toward banks as a whole, as observed in the BKX (the Keefe, Bruyette, and Woods Bank Index which consists of 24 banks), which declined 7.7% on Thursday and is down over 12% since the start of the week (as of the close on 3/9/2023).

While some investors may be placing all banks into the same basket, there remain significant differences in composition and quality between banks. The two banks that were most directly caught in the crosshairs are generally defined as "niche" banks, at least through the lens of funding, and were closely tied to crypto and young, emerging tech companies. Any disruption in these specific markets was likely going to have an outsized effect on these institutions and is evidenced by the events leading up to this past week (for example, the failure of FTX).

While certainly a headwind for the industry, most banks (non-niche banks) are more diversified and should be far less exposed to any single option when it comes to funding. Furthermore, the larger the bank, the more diversified the funding, as the larger banks operate in many different arenas. This setup should also lead to "stickier" deposits, another positive.

Deposits are a primary source of funding for most banks – it is the capital that allows them to make loans. In the aftermath of the pandemic, deposits swelled as the world became awash in liquidity. Deposits increased so much, however, that banks had "excess liquidity" and with these funds, they purchased fixed income securities.

As the Federal Reserve raised rates, some of these securities have incurred unrealized losses. And some banks who have experienced declining deposits have had to sell these securities, realizing losses and/or accessing capital from other, more expensive sources which has impacted bank profits.

While funding pressures may exist across the banking sector as rates increase, on average, banks should be positioned to manage through this environment. This does not mean that the potential for additional underperformance is off the table, especially for select stocks. Banks with the most "catch-up work" to do on funding costs, relative to the banks that have already adjusted costs, could experience underperformance over the near-term given the recent attention.

Overall, our current view is that the banks affected this week were isolated situations that ultimately ended up hurting the sentiment of the group, but we do not think this is the beginning of a large-scale funding crisis. Fully understanding the fundamentals and risks associated with each bank in the sector will remain important factors when it comes to security selection.

That said, we acknowledge this is a fast-moving situation that could have spillover effects to smaller, less well-capitalized banks and perhaps other segments of the economy and various parts of the investment landscape. We will be monitoring many things closely in the days and weeks ahead, and we will continue to communicate our thoughts as they evolve.

For more information, please contact your advisor.

About the Author

Michael Sroda is a Senior Lead Research Analyst on the Equity & Fixed Income Research team in the Key Private Bank Investment Center. Within the Equity Research team, he is responsible for the coverage of Consumer Staples, Financials, Real Estate Investment Trusts, and Utilities. His Fixed Income Research responsibilities include providing credit support to both the Municipal Investments team and the Taxable Investments team, as well as the surveillance of all individually held fixed income investments at Key Private Bank. Prior to joining Key in 2009, he worked as a Financial Reporting Analyst at National City Bank. Michael holds a Bachelor of Business Administration (BBA) with a concentration in finance from Kent State University and received his Master of Business Administration (MBA) from John Carroll University. His professional memberships include the CMT Association, CFA Society of Cleveland, National Federation of Municipal Analysts (NFMA), and Chicago Municipal Analysts Society (CMAS).

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