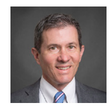
What Does the Stress in Regional Banking Mean for U.S. Smaller Companies?

The banking sector is an integral part of the U.S. small-cap investment universe.

May 2023



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KEY INSIGHTS

- The impact of recent failures in the U.S. banking sector, and the rapid withdrawal of deposits across some regional U.S. banks, has been profound.
- For smaller company investors, the stress in the U.S. banking sector is acutely relevant given that regional banks represent a key component of the investment universe.
- While the recent crisis has been destabilizing, at this stage, few regional banks appear to be exposed to similarly severe liquidity and/or concentration risk.

March 2023 marked a period of extreme duress in the U.S. banking industry, with ripple effects around the globe. Two U.S. banks, Silicon Valley Bank (SVB) and Signature Bank (SBNY), collapsed after both suffered runs on their deposit base. At the time of writing, a handful of other banks have faced liquidity pressures. On May 1, 2023, First Republic Bank (FRC)[1] was seized by U.S. regulators and substantially all assets have been purchased by JP Morgan Bank. The impacts of these failures, and the rapid withdrawal of deposits across some regional U.S. banks, has been profound. For U.S. smaller company investors, recent developments are acutely relevant given that regional banks—there are 216 of them listed on the Russell 2500 Index[2]—represent a key component of the small- and mid-cap (SMID) company investment universe. With this in mind, we consider the outlook for U.S. regional banks and their potential impact within smaller company portfolios.

The Issue Today Is Liquidity, Not Credit

An important distinction between the crisis SVB and SBNY faced in 2023, and what occurred during the global financial crisis (GFC) of 2008 and 2009, is that today's crisis is driven by liquidity issues, not credit issues in banks' loan portfolios. The GFC was chronic stress in the loan portfolio that took years to build up. Once the issue was uncovered,

[1] First Republic Bank (FRC) is not included in the Russell 2500 Index, and we had no exposure in this strategy's representative portfolio as of March 31, 2023. The representative portfolio is an account we believe most closely reflects current portfolio management style for the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio shown may differ from those of other accounts in the strategy. Information regarding the representative portfolio and the other accounts in the strategy is available upon request.
[2] As of March 17, 2023. Source: Frank Russell Company "LSE."

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banks could identify how much capital was required and raise the capital, and then the crisis was relatively controlled.

No bank can control the outflow of deposits it may face—either the magnitude or the timing. The amount of capital needed to fund the sheer volume of withdrawals that SVB, SBNY and FRC faced was more than could be raised in the time they had available.

Not All Banks Face the Same Fate

The media is focused on a handful of banks under extreme pressure, and the coverage of the issues these banks are experiencing is warranted given the potential for broader impacts on the financial system. That said, the reality is that a large portion of the regional bank universe has not faced material outflows of deposits. In the week following the collapse of SVB and SBNY, the large majority of regional banks had either seen no material change in deposits or had seen positive deposit flows. Larger money center banks, perceived as "too big to fail," are to some extent gaining deposits at the expense of the regional banks, but the shift has been muted, to date.

Wide Distribution of Bank Performance, Post Collapse

There are 216 regional banks in the Russell 2500 Index and relatively few of them are currently facing the same financial or stock performance issues as SVB and SBNY. From SVB's failed capital raising on March 8, 2023, through to the time of writing on March 17[3]:

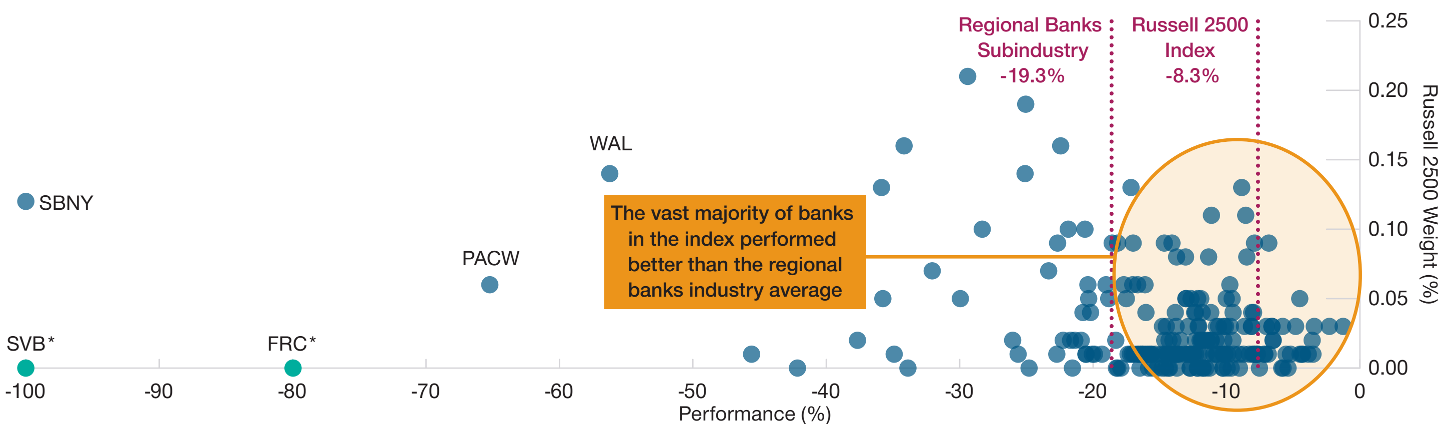
- 176 of those banks outpaced the regional banks subindustry average return of -19.3%
- 40 outpaced the Russell 2500 Index return of -8.3%

Looking Deeper Into the U.S. Regional Banking Subsector

The three principal issues that led to the demise of SVB and SBNY had to do with the degree of customer concentration, the proportion of uninsured deposits,

Russell 2500 Regional Banks* Performance By Index Weight

(Fig. 1) Extreme pressures were felt by only a few (left hand side) in the industry



As of March 17, 2023.

Past performance is not a reliable indicator of future performance.

The specific securities identified and described are for informational purposes only and do not represent recommendations.
Performance period covered is March 8 to March 17, 2023. Data and information provided is subject to change.
SVB = Silicon Valley Bank; SBNY = Signature Bank; FRC = First Republic Bank; PACW = PacWest Bancorp; WAL = Western Alliance Bancorp.
* SVB and FRC are shown for illustrative purposes as both companies are not listed in the Russell 2500 Index.
Sources: FactSet, Frank Russell Company "LSE." Analysis by T. Rowe Price (see Additional Disclosure).

[3] As of March 17, 2023. Sources: FactSet, Frank Russell Company "LSE." Analysis by T. Rowe Price.

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and the duration of the asset portfolio. With this in mind, our banking analyst team has essentially "stack ranked" the banks in their coverage universe on these factors.

Our analysis shows that no other regional banks—of the nearly 100 in scope—have the same highly concentrated customer bases as did SBNY (New York City real estate, crypto-currency deposits) and SVB (venture capital/technology/life science start-ups). Most regional banks have uninsured deposits in the range of 3% to 20% of their total deposits (compared with approximately 90% for SBNY and SVB) and, importantly, have the liquidity on hand to meet withdrawals if needed. To the latter point, of all the banks analyzed, only one saw greater than 2% deposit outflows in the week immediately following the demise of SVB and SBNY. Finally, we stress-tested the banks' capital as if all securities were marked to market—large banks are already required to do this—so the same standard was applied to smaller local and regional U.S. banking counterparts. Our findings show that only a small number would need to raise capital. In these instances, suspension of buybacks and dividends exist as tools to help those that need to achieve this target.

Unsurprisingly, there have been rating changes within our U.S. banking sector universe—both upgrades and downgrades—in the immediate aftermath of the recent collapses. As we reassess the risk and reward presented by the banking sector, there have been opportunities to both trim and add, as is often the case when a broad sector of the market faces indiscriminate selling.

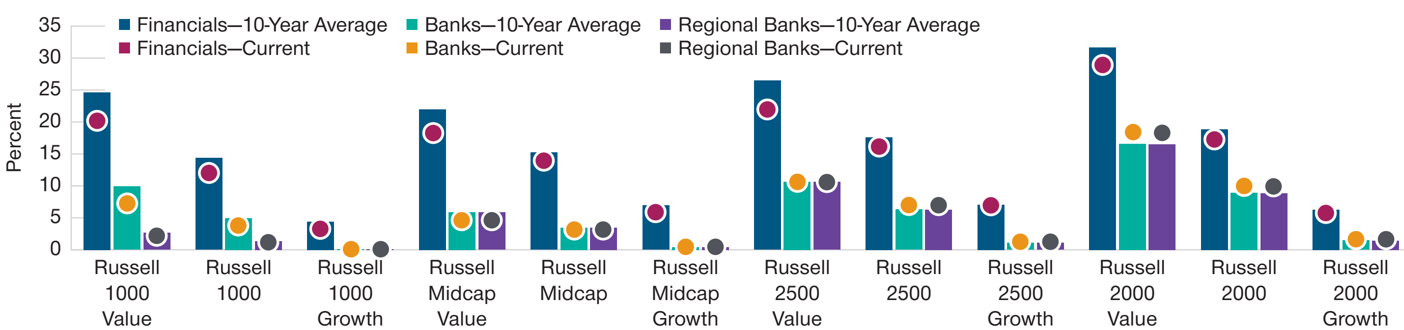
Regional Banks Are a Meaningful Portion of the Universe

We continue to have a broad exposure to small- and mid-cap U.S. banks. This "basket" approach achieves a diversified exposure to a particularly attractive subset of the U.S. equity market. In the SMID-cap portion of the market, there are no national players. Instead, banks serve more narrowly defined markets, perhaps a few states or even a few cities within a single state. In this industry, our analysts select banks that offer attractive market opportunities, such as exposure to cities and states with above-average population or business growth. Recent developments have also highlighted that some regional banks are more at risk due to their exposure to a specific type of customer.

This illustrates again the risk of a lack of diversification in the banks themselves, one that leaves such names vulnerable to "groupthink" (like SVB and SBNY) or other correlated behaviors.

Russell Index Exposure to Financials, Banks, and Regional Banks

(Fig. 2) Regional banks are particularly prominent in SMID and value-oriented indices



As of March 17, 2023, both Current and 10-Year Average Index Weightings.
Sources: FactSet, Frank Russell Company "LSE." Analysis by T. Rowe Price (see Additional Disclosure).

However, our analysis suggests that few other regional banks have similarly concentrated customer bases, nor do they have customers with such large proportions of uninsured deposits. Hence the "average" U.S. regional bank is less vulnerable to the forces that ultimately led to the failures of SVB and SBNY.

Regional Banks Allocation Within Russell Style Indices

In the wake of the recent banking turmoil, a key question from investors has been: How much exposure do Russell U.S. equity indices have to regional banks? The short answer is that it varies, but regional banks have long been a large allocation within the SMID-cap space, in particular. There is clearly nuance across specific indices and investment styles, with regional banks being a larger allocation down the market cap scale and within value-oriented indices.

In Figure 2, above, we show the respective weightings of financials, banks, and regional banks, within the range of Russell U.S. equity indices—currently and versus the 10-year average, both as of March 17, 2023.

What Lies Ahead for U.S. Regional Banks?

The exact details of the following highlighted points are still in flux, but our expectation is that the environment for regional banks will shift following this recent crisis, with the main impacts being felt in the following areas:

Regulation and Legislation

As mentioned, the specifics here will evolve over time, but we do anticipate that the regulatory environment for the regional banking universe will tighten as a result of the failures of SVB and SBNY. It was reported in the press earlier in March 2023 that the Federal Reserve (Fed) was looking at lowering the asset threshold for tougher capital, liquidity, and annual stress-testing requirements to USD 100 billion, from the current USD 250 billion level.

Gridlock in Washington likely delays any new legislation to address the issues banks are facing. It would take an act of Congress to explicitly raise (or remove) the Federal Deposit Insurance Corporation (FDIC) deposit insurance cap. Such a move might help calm depositors' nerves and inject some stability and confidence in the industry, but it is not expected to happen in the current political environment.

Costs and Revenues

Banks are already facing increased deposit costs in a rising rate environment. Increased regulation further increases the cost of doing business. As such, banks will likely face additional costs associated with whatever level of regulation ends up coming down. Additionally, given that banks ultimately fund the FDIC, the takeover and insurance on deposits from SVB and SBNY will likely lead to higher premiums for FDIC-insured banks.

In a higher-cost, more cautious environment, the appetite for these banks to make new loans is expected to moderate. This will constrain their growth going forward; it will also serve as another factor to slow the U.S. economy, perhaps taking the place of some future tightening by the Fed.

Lower Valuations for the Industry

In addition to, and because of, the regulatory and cost burdens discussed above, banks are likely going to experience multiple compression, at least for some time. Prior to the recent failures, bank stocks were already trading below long-term averages (more than one standard deviation, actually), but the recent crisis likely keeps levels lower.

Failures Are Destabilizing, but Any Wider Threat Appears Limited

The impact of recent failures in the U.S. banking sector, and the rapid withdrawal of deposits across some other regional U.S. banks, has certainly been destabilizing—not only for the industry, but also for the broader U.S. equity market. Nowhere has this been more acutely relevant than for U.S. small- and mid-cap company investors, given that regional banks represent such a major component of the investment universe. However, based on our detailed analysis, we are comfortable, at this stage, that few regional banks are exposed to the kind of severe liquidity and concentration risk as experienced by SVB and, latterly, FRC. Accordingly, we are finding attractive opportunities where better-quality banking stocks have been oversold relative to their idiosyncratic risks. We continue to maintain a broad exposure to small- and mid-cap U.S. banks, diversifying both the risk and reward potential offered by this attractive subset of the U.S. equity market.

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Risks—The following risks are materially relevant to the portfolio:

Small and mid-cap—Small and mid-size company stock prices can be more volatile than stock prices of larger companies.

General Portfolio Risks:

Equity—Equities can lose value rapidly for a variety of reasons and can remain at low prices indefinitely. **ESG and sustainability**—ESG and Sustainability risk may result in a material negative impact on the value of an investment and performance of the portfolio. **Geographic concentration**—Geographic concentration risk may result in performance being more strongly affected by any social, political, economic, environmental or market conditions affecting those countries or regions in which the portfolio's assets are concentrated. **Investment portfolio**—Investing in portfolios involves certain risks an investor would not face if investing in markets directly. **Management**—Management risk may result in potential conflicts of interest relating to the obligations of the investment manager. **Market**—Market risk may subject the portfolio to experience losses caused by unexpected changes in a wide variety of factors. **Operational**—Operational risk may cause losses as a result of incidents caused by people, systems, and/or processes.

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