Is There Another Crisis Coming for Banks?

As we head into 2024, there's a harsh reality awaiting banks: commercial real estate could be the next domino to fall. Will they be prepared?

Paul Chi
Research Analyst, 1623 Capital

Q4 2023

info@1623capital.com • 703-832-8232

1623 Capital

For most of the world, the pandemic was the most significant collective event of our lifetimes. In short order, governments around the world locked down their populations. Many restaurants and retail stores were forced to shut down for good due to a sudden loss of foot traffic. Those who were able to work from home found that they had to adapt to using video conferencing for collaboration in lieu of in-person meetings.

Millions of people found themselves trapped in their homes, unable to go out and spend money as they did previously. Stuck at home, people proceeded to buy tons of stuff. The global supply chain was not ready for a buying surge of this magnitude, and soon became very snarled up. Remember the gridlock outside the Los Angeles ports or the chip shortages that hampered vehicle production and caused car prices to skyrocket? That was just a few short years ago.

As economies opened back up, people shifted from buying goods to services. The phrase "revenge travel" entered our vernacular as people around the world traveled and lived life to the fullest. The surge in demand for goods and services, combined with stimulus checks that bolstered consumer balance sheets, helped fuel a rapid increase in inflation. After a long period of low inflation in the United States, the Consumer Price Index (CPI) increased at a 9.1% year-over-year rate at its peak in June 2022.

Facing the highest inflation since the 1980s, the Federal Reserve (Fed) sprang into action to fulfill its mandate of price stability, which calls for maintaining an inflation rate of 2%. Thus, the Federal Reserve started raising rates last year at a rapid pace in order to combat inflation. In fact, the Fed went from 0% interest rates at the beginning of 2022 to over 4% before year end. The hiking cycle included a whopping four straight 75-basis-point hikes, demonstrating the urgency felt by the Fed as it dealt with the spike in inflation. Today, the Federal Funds rate is 5.25% to 5.50%.

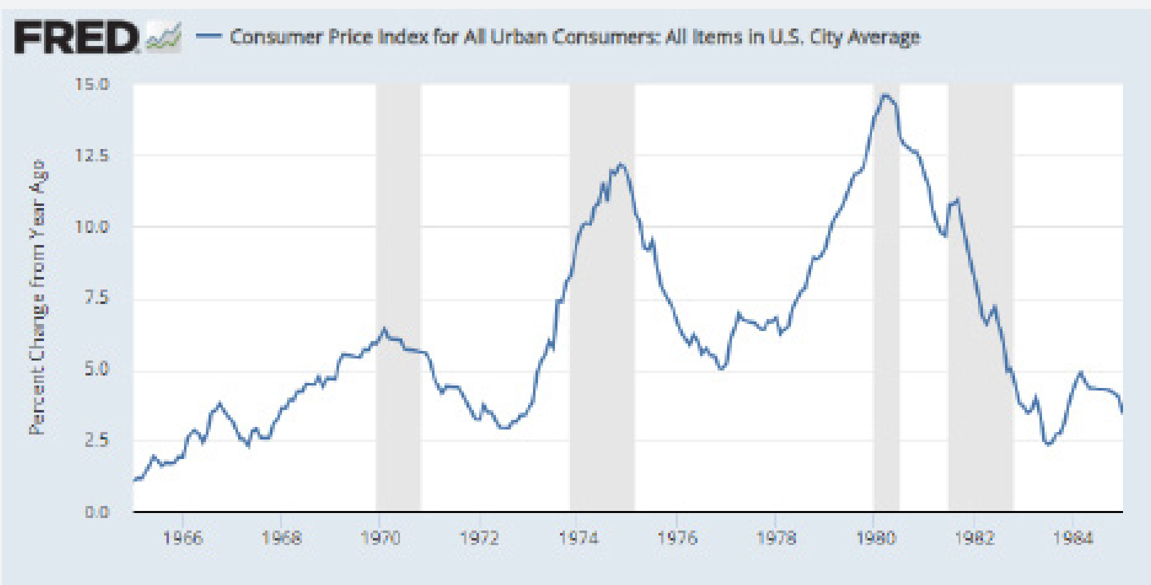
Just like the inflation before it, these interest rate hikes were very jarring, and had ramifications across sectors—among the most profoundly affected was the banking sector. "Duration" is a concept in the bond world used to describe how sensitive a bond is to changes in interest rates. As a rule, long-term bonds are much more sensitive to changes in interest rates than short-term bonds. This means that if interest rates rise sharply, long-term bonds will fall in price much more than short-term bonds (as a refresher: bond prices have an inverse relationship to bond yields). This makes sense since short-term bonds mature much earlier and can be reinvested into new market-rate bonds much more quickly.

It can be tempting to buy long-term bonds to earn a higher yield on one's bond portfolio. Of course, it's not very pleasant if interest rates rise after one has purchased a bundle of long-term bonds. Unfortunately, that's exactly what happened to the banking sector. Many banks stuffed their balance sheets with long-term bonds while rates were still low. That reckless obsession with a couple extra basis points eventually led to a brutal hit to bank balance sheets as the Fed raised rates sharply, culminating in the collapse of Silicon Valley Bank (SVB) and Signature Bank in March of this year. By the time the banking crisis claimed one more casualty in First Republic Bank on May 1, the KBW Nasdaq Bank Index, affectionately known as the BKX, was down 21% for the year.

Two more banks have failed since then, but these were much smaller institutions. Shocked into action by the banking panic, management teams across the banking sector have spent time fixing their balance sheets and trying to assess what other risks might materialize due to the high-rate environment. Are things all better now, or are the troubles just beginning?

Shaped by Our Past

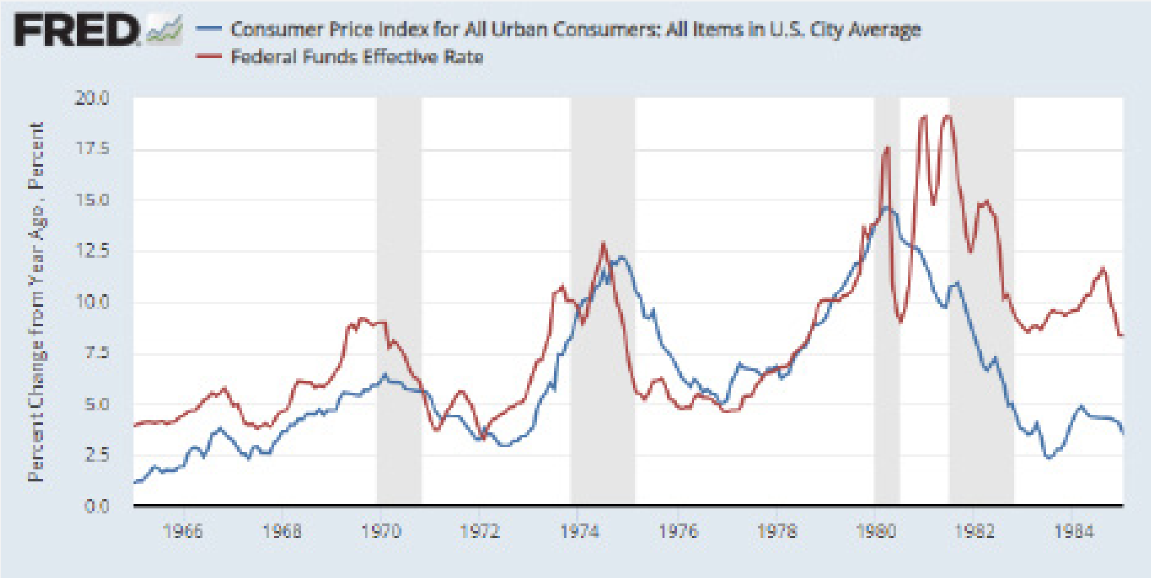
To get the full picture, we have to go back to the 1970s—a tough era, economically speaking. We had low growth and high inflation, a deadly combination. There were two separate oil shocks, caused by the Arab Oil Embargo and a collapse in Iranian production following the Iranian Revolution and the Iran-Iraq war. That helps explain the three waves of inflation we faced back then:



Source: U.S. Bureau of Labor Statistics.

 info@1623capital.com | 703-832-8232

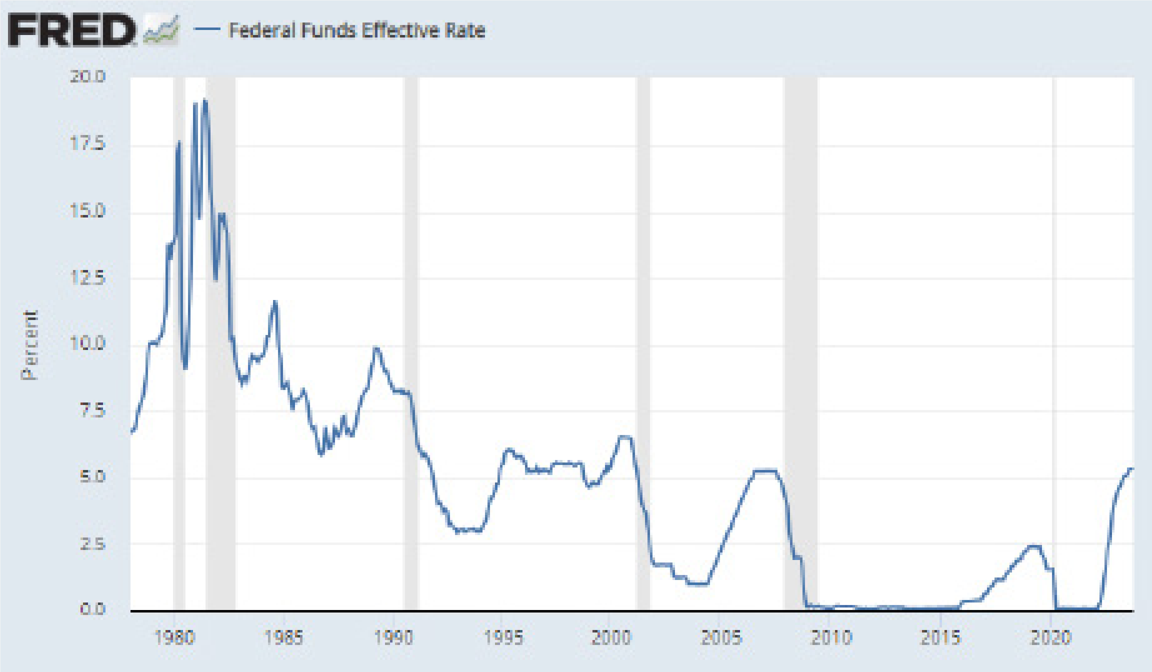
Just like the Fed of today, the Fed back then raised interest rates to combat the high inflation. It wanted businesses and consumers to save, not spend. However, inflation just kept coming back. So when Paul Volcker was appointed to vanquish inflation for good in 1979, he ultimately kept the Federal Funds rate persistently higher over a multi-year period, causing a double-dip recession. Below, we see CPI and the effective Federal Funds rate during those three waves of inflation:



Source: Bureau of Labor Statistics.

Even after all the hikes so far over the past two years, the Federal Funds rate has been set at a range of 5.25% to 5.50%. In the above chart, we see that the Fed went well above today's range in all three of those hiking cycles. It's hard to grasp how drastic the inflation problem was in the 1970s until we really take some time to let those numbers sink in.

Because the Fed had to set interest rates so high back in the 1970s and 1980s, interest rates could really only go down from there. And go down they did:



Source: Board of Governors of the Federal Reserve System (US).

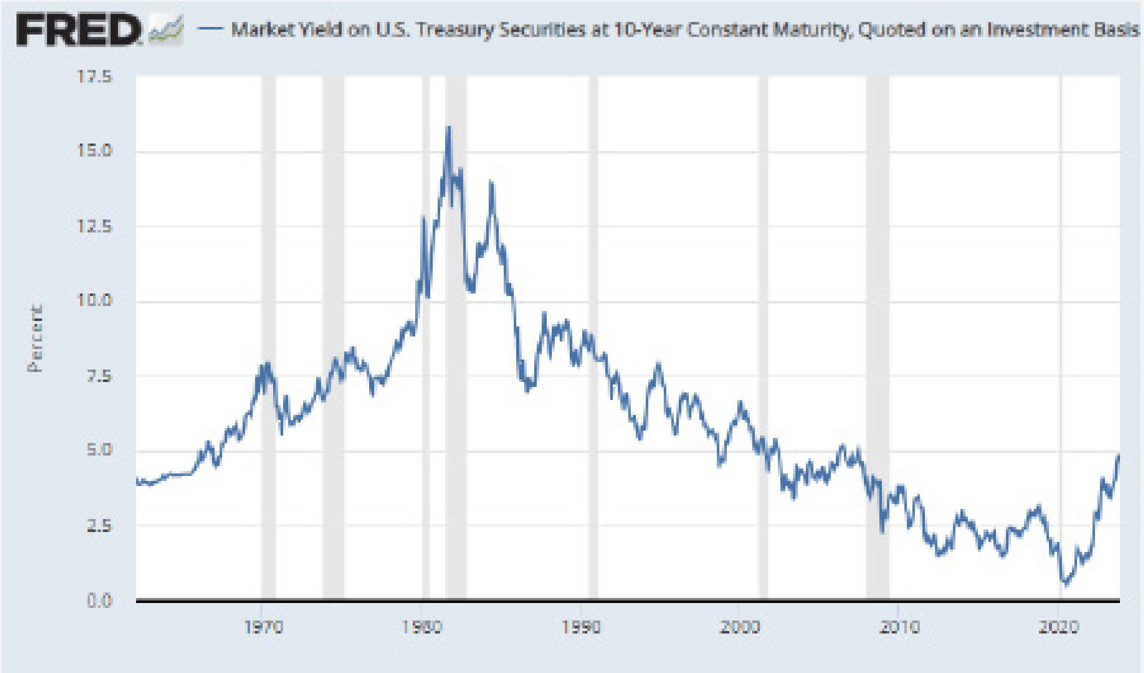
We see above that interest rates basically went lower and lower—until reaching zero-bound after the Great Financial Crisis (2008/2009). An entire generation of finance professionals came of age when interest rates were zero—they don't remember any other period in time. Sadly, very few people working in finance today were around 40-50 years ago when interest rates were in the double digits.

Due to the inverse relationship between bond yields and prices, when bond yields come down, that means the price goes up. From 1980 to the early 2020s, bond managers enjoyed a golden era of consistently stable or rising prices. Sure, inflation didn't go down in a straight line. But the overwhelming trend was in favor of bond prices rising. However, once rates hit zero, they didn't have any lower to go. Finally, the zero-rate environment had arrived.

An entire generation of finance professionals came of age when interest rates were zero—they don't remember any other period in time.

The Federal Funds rate went to a range of 0% to 0.25% on Dec. 16, 2008, in response to the immense pressures faced by both the banking sector and the economy as a whole. As we now know, the zero-to-low-rate environment that followed 2008 was an incredible time for risk assets. From the Fed's December 2008 rate cut to the first post-pandemic hike on March 17, 2022, the S&P 500 gained 383% in value, going from 913.18 to 4411.67.

Zero interest rates also allowed houses to become very affordable as mortgage rates plummeted. Companies freely took on debt to buy back stock and acquire other companies. The 10-year Treasury note, often cited as the "risk-free rate" against which other assets are measured, saw its yield plummet to under 1% at its low in 2020. The long-term chart is truly something to behold:



Source: Board of Governors of the Federal Reserve System (US).

It's no wonder that we started hearing acronyms like "TINA," which stands for "There Is No Alternative"—to risk assets, that is. After a multi-decade decline in interest rates and a decade-plus of ultra-low rates, the yield on typical investing instruments such as long-term Treasuries and mortgage-backed securities became extremely unattractive. As previously issued fixed-income instruments matured, new instruments were issued at the new low rates. After many years of this, as you might imagine, the fixed-income space started to become rather unattractive.

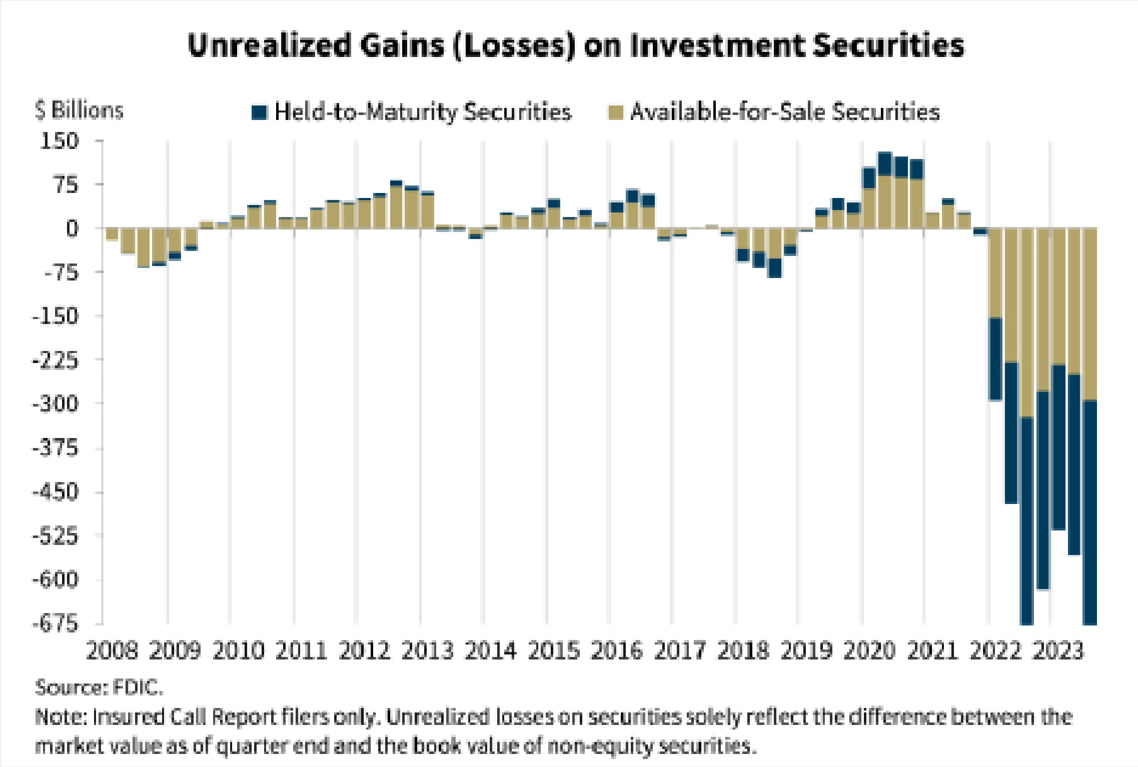
Mistakes Were Made

Let's return to the banks. How do banks make money? The simplest version is that they take in deposits and make loans with that money. The deposits are liabilities, the loans are assets. On the average publicly traded bank that you've heard of, there are probably many billions in assets and liabilities. On the asset side, you'll find loans: car loans, credit card balances, home equity loans, and mortgages. You'll also find short-term and long-term bonds parked in the bank's investment portfolio. On the liability side, you see instruments on which the bank pays out interest, such as checking and savings accounts, certificates of deposit, preferred stocks, or even debt.

A bank's purpose is to keep your deposits safe, first and foremost. But after that basic need, the bank likes to earn interest income over time. The bank does this by borrowing money through deposits and debt (hopefully at a low cost) and then lending it out at a higher rate. The difference in interest earned by assets and the interest paid out on liabilities is called the net interest margin (NIM). A high NIM typically helps the bank earn more net profit over time, which should lead to a higher share price. Thus, banks have to satisfy shareholders by increasing profits over time, but also stay on the right side of regulatory ratios and requirements. Unfortunately, we know from history that many banks fail that test, often taking too many risks.

During the post-pandemic boom, SVB received large inflows of deposits. SVB had $61.9 billion in deposits in the first quarter of 2020. From there, deposits more than tripled to $198 billion just two years later. SVB did make nearly $33 billion in net loans during that time, but the bank's investment portfolio grew by about $100 billion. Unfortunately, we now know that a lot of that cash was placed in long-term Treasury securities. During a time of ultra-low rates, management decided to go far out on the duration curve in search of a few extra basis points of yield for its newfound cash hoard. That meant buying up long-term Treasuries right before the prices of those bonds plummeted.

When the prices of those bonds started to plummet, investors started worrying about whether the bank was solvent. After all, a bank's assets (which include its investment portfolio) are supposed to serve as capital against which loans can be made, or deposits can be withdrawn. As we see below, SVB was not alone in buying up long-term bonds *at precisely the worst time*. In fact, it seems like many banks did the exact same thing, according to the FDIC:



Source: FDIC.

SVB had the misfortune of being among the most vulnerable to sharp rises in interest rates. It's not all that surprising that it ended up failing, given what we know now. Still, the actual manner in which the bank failed was pretty shocking. This title from a March 2023 CNN article says it all:

"SVB collapse was driven by 'the first Twitter-fueled bank run'"

According to CNN, customers withdrew $42 billion in a single day and left the bank with a negative $1 billion cash balance. Articles about bank runs typically include pictures of people standing in line outside a bank branch to withdraw their cash. The line usually wraps around the building, showing the severity of the situation. However, this bank run was completely different. In the digital age, people can withdraw their funds at the tap of a screen. That introduced a whole new risk to the bank business model that had not been seriously considered before. Also, this new type of bank run called into question whether previous regulations were sufficient to withstand the interest rate environment.

Playing Regulatory Catch-Up

What's interesting about the failure of SVB earlier this year is that on the surface, the bank looked quite solid right before it collapsed. The bank's 2022 year-end Basel III disclosures (the one it made right before its collapse) showed that its regulatory capital ratios were well above the required minimums. As far as we know, there wasn't any evidence of widespread credit defaults that would come from its loan book. Months after the bank failures, we know that sharply rising interest rates caused the bank failures this year. The logical question is: Why don't we test for that?

The answer lies within the global response to the financial crisis. Among the reasons for the global financial crisis were lax lending standards that led to the creation of monstrosities such as the NINJA loan ("no income, no job, no assets"). That sounds horrible on the face of it. Why in the world were banks giving loans to people who had no means of repaying them in the first place? It was an idiotic concept, yet it was surprisingly common during the U.S. housing bubble that preceded the financial crisis.

Along with the lack of lending standards, many banks dialed up the leverage considerably. In hindsight, it's not hard to see why the financial crisis happened in the first place. What happens when banks make numerous stupid loans with not enough capital to soak up the losses as those loans go bad? You get the worst financial crisis in many decades.

Obviously, regulators did not want this type of thing to happen again. The landmark piece of regulation following the crisis was the Basel III framework. The framework is published by the Basel Committee on Banking Supervision, a committee started by the G10 countries after some turbulence in financial markets in 1974. As its name suggests, Basel III is the third iteration of the committee's framework. After the initial release, it has been revised and updated over time.

Basel III requires banks to have much more regulatory capital, a minimum leverage ratio, and improved risk management, among other things. Banks also tightened their lending standards, having been scarred by the near-death experience of 2008-2009. Honestly, the stricter regulations did have their intended effect. Banks appear to be healthier today than the days before the financial crisis. In addition, the "too big to fail" banks such as **JPMorgan Chase** and **Bank of America** are regulated much more heavily than smaller banks. As a result, the larger banks are much healthier than regional banks today, in my view.

While the new regulations following the global financial crisis created more well-capitalized banks, we have to remember that SVB's problems were caused by rising interest rates lowering the value of their long-term bonds. In response to the banking crisis earlier in the year, regulators in the United States are looking to strengthen capital requirements even further, building on the previous regulations in what's been dubbed the "Basel III Endgame." Under this new proposed framework, banks with $100 billion or more in total assets would face tougher capital requirements. These banks would also have to "include unrealized gains and losses from certain securities in their capital ratios."

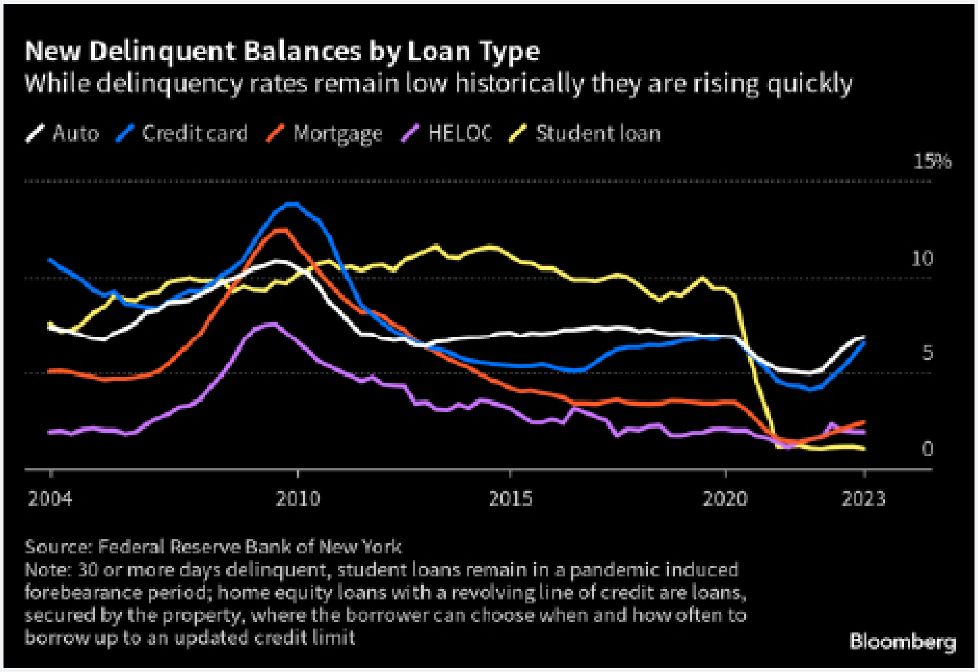
The portion about including unrealized gains and losses from certain securities in their capital ratios is a nice step that might lessen the severity of rising rates on banks' investment portfolios in the future, since banks might be more careful about having too much duration in their bond portfolio. It's interesting to see the renewed focus on increasing regulatory capital, given that what sank the banks earlier this year was the rising rate environment and not a lack of regulatory capital. We'll be watching to see if the Basel III Endgame will pass as proposed, or if there will be additional changes to come.

It's Not Over

SVB and the other failures were primarily due to their own bond investment portfolios losing value because of the long duration bonds that went down in price as interest rates rose sharply. Now, banks are gearing up for another potential domino: credit risk. Unlike during the Global Financial Crisis, banks aren't carrying around radioactive home loans on their balance sheets. This time, residential mortgages are in relatively good shape. During the low-interest-rate period that we just had since 2010, many consumers did the right thing and refinanced their loans to fix the low rates over a long time period (30 years, typically).

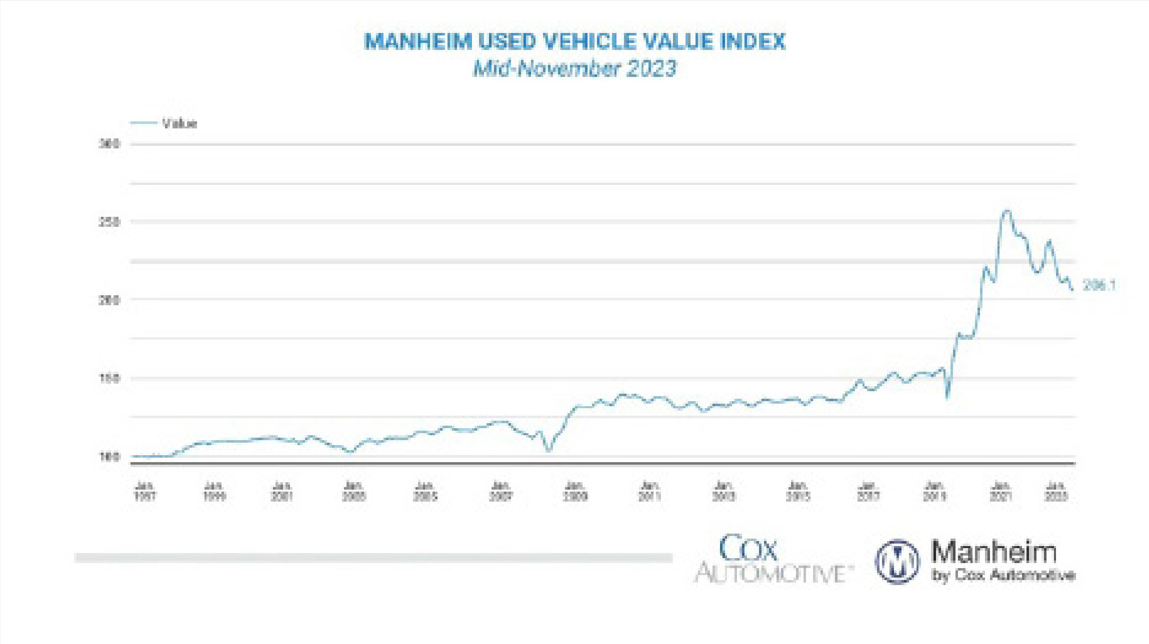
According to a report from Redfin, around 80% of U.S. homeowners had an interest rate below 5% as of June of this year. More than half of U.S. homeowners had an interest rate below 4%. With so many people locked into low-rate mortgages, it's no wonder that there are few sellers these days. If those homeowners want to sell their homes to buy another one, they would have to pay a much higher interest rate on the new property, likely increasing their monthly payment by a sizable amount. That's been one of the factors keeping housing inventory low. Homeowners with locked-in mortgages simply do not want to leave.

If mortgages aren't flashing a warning sign, where might the next problem area be? The graphic below shows that as interest rates have risen, auto loans and credit cards have started to show increases in the percentage of borrowers who are 30+ days delinquent:



Source: Federal Reserve Bank of New York, Bloomberg.

Credit cards going delinquent at a higher rate seems pretty self-explanatory. More consumers are struggling than a few years ago as pandemic-era savings have started to dry up, so more of those borrowers are delinquent today. But the auto loan market has an interesting factor that's worth noting: used car prices went parabolic during the chip shortages and snarled up supply chains that followed the pandemic lockdowns. You can easily spot it in the following chart:



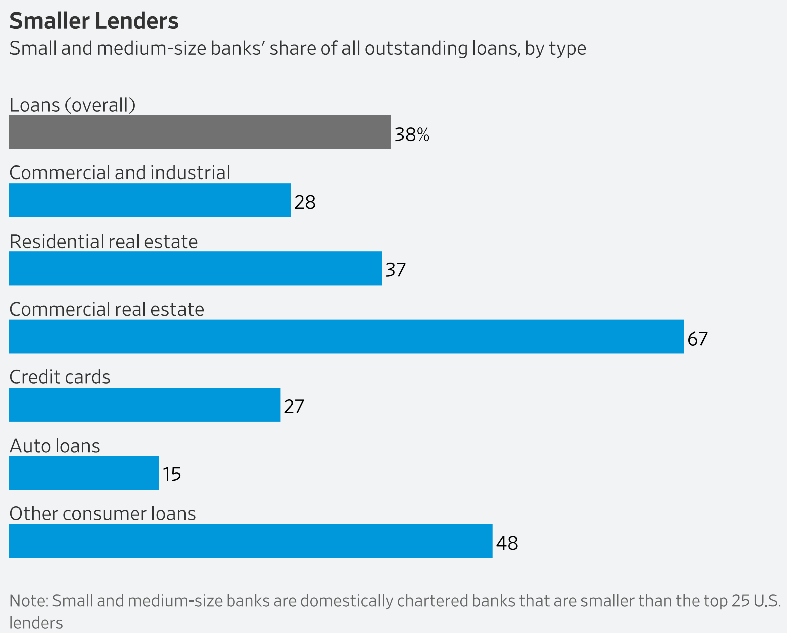
Source: Cox Automotive.

Some consumers are likely feeling the heat from paying exorbitant prices for their cars. Those loan payments are simply far higher than they should be, had those cars been sold in a more normal price environment.

Feeling Upside Down

Today, the loans most subject to sticker shock are refinancings. When we typically think of refinancings, we think of borrowers who want to lower the rate of their home loan or corporate debt. Unfortunately, refinancing needs can go the other way as well. Sometimes, a low-rate loan or bond matures, but the borrower needs to roll the proceeds into a new borrowing, rather than pay it off. In today's environment, borrowers with debt maturing have been putting off refinancing for as long as possible, hoping that interest rates will come back down. As the Fed kept its "higher for longer" stance going, more and more market participants have come to believe that the Fed is indeed serious about keeping rates high.

If you pay regular attention to financial media, you've surely heard about the problems with commercial real estate. Let's take a closer look at this space:



Source: Federal Reserve, Wall Street Journal.

The above graphic shows what percentage of total loans of each type are held by banks outside the top 25 U.S. banks. For example, the smaller banks in the U.S. are responsible for a whopping 67% of commercial real estate loans. It is the only category in which the top 25 banks are responsible for a minority of the loans outstanding. Unfortunately for the smaller banks, commercial real estate has been rightly identified as one of the potential problem areas of the next five-plus years.

The smaller banks in the U.S. are responsible for a whopping 67% of commercial real estate loans. It is the only category in which the top 25 banks are responsible for a minority of the loans outstanding.

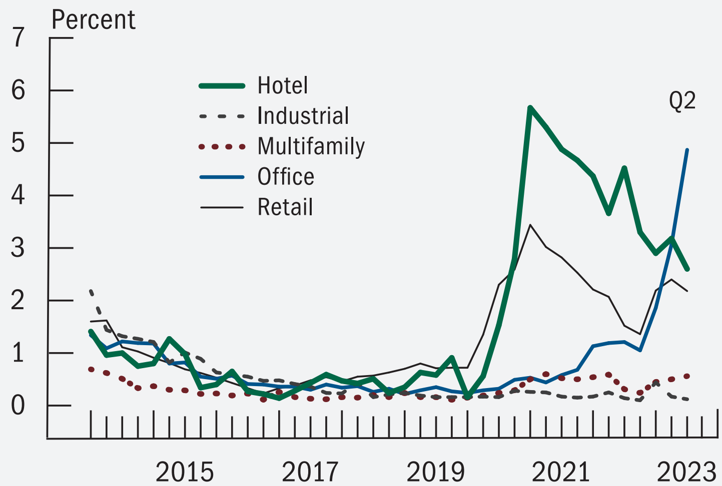
Back in April, as the regional banking crisis was occurring, Bloomberg reported that a $1.5 trillion "maturity wall" was set to come due for repayment through 2025. Commercial Real Estate Direct has estimated that $2.75 trillion in commercial real estate loans are coming due between 2023 and 2027. In either case, it seems like commercial real estate loan holders have a lot of refinancing to do. Unlike conventional mortgages, commercial mortgages are often shorter in term, often ranging from five to 10 years. In addition, some commercial mortgages are interest-

1623 Capital

only, meant to be refinanced at a later date. It's not hard to imagine interest-only loans from the low-rate era having a hard time receiving refinancing today.

Although commercial real estate has been widely lambasted in the media, it's important to note that the different types of commercial real estate have been performing very differently over the past five years. This graphic below from the Federal Reserve's November 2023 Supervision and Regulation Report highlights the difference in delinquency rates between the various types of loans:

Figure 6. Income-producing CRE loan delinquency rates by property type



Note: Delinquent loans are those 30+ days past due or in nonaccrual status.

Source: FR Y-14Q.

Source: Federal Reserve.

As the lockdowns occurred in 2020, we see that retail and hotel properties started to become delinquent in a huge way. However, as economies around the world reopened, their prospects have been steadily improving. The one space that's gotten worse—in a hurry—over the past few years is the office space. A lot of companies have gone from five days in the office before the pandemic to just two or three days in the office. Since many companies went hybrid or are fully remote, a lot less office space is needed in the aggregate. That leads to lower occupancy rates and lower rental income for the building owners. Meanwhile, loans are coming due.

Each time a loan comes due, borrowers are doing the math to see if they should refinance or simply hand the keys back to the bank. Higher prevailing interest rates guarantee much higher monthly payments, even as rental income for the borrowers is heading lower. It's a situation that's leading to many upside-down borrowers, meaning that they owe more than the property serving as collateral for the loan. Those upside-down borrowers often have to resort to doing things such as asking for partial principal forgiveness, offering additional collateral to right-size the loan-to-value equation, or paying down some of the principal immediately just so the new loan can meet current underwriting standards.

Some building owners have been handing their keys back to the banks since the math simply doesn't work out. In this circumstance, the value of the building has fallen too much and the bank wants more guarantees before making a loan on a building that has become much riskier, given the decreased rental incomes and reduced building valuations these days. In other cases, banks are utilizing the "extend and pretend" strategy, which is a tactic used by banks during unfavorable conditions. Essentially, lenders using this strategy work with the borrower to extend terms, hoping to wait out the unfavorable conditions and pursue a refinancing or other course of action at a later date, when conditions have hopefully improved. In today's market, that means hoping the Fed lowers interest rates by several percentage points—in quick fashion.

Before we start panicking about regional and mid-sized banks because of their office tower exposure, it's important to remember that when these banks receive the keys to a building, they can sell that building for some amount of money. Thus, any defaulted loans are unlikely to end up as total losses of capital for these banks. There will be a partial recovery of capital as they sell off the buildings they receive when borrowers default. Of course, even a partial loss of capital has the potential to hurt a bank's balance sheet and hinder its ability to offer fresh loans.

More Pain Ahead

We've seen that the banking troubles started popping up right in the middle of the Fed's rate-hiking campaign. That's not too surprising, since the business model of banking literally involves earning a higher rate on one's assets than on one's liabilities. So when are rates going back down meaningfully from here? That is the question. As with many things in life, it's just impossible to know.

Soft landing or not, it's hard to imagine how the banking sector will come out of the next few years unscathed.

Market participants have been hopeful of the elusive soft landing, in which the Fed is able to orchestrate a decrease in inflation without hurting the economy so much that the unemployment rate starts to rise sharply. After vanquishing inflation in such a scenario, the Fed would then be free to lower interest rates back down to a lower rate that doesn't slow down lending so much. Whether the Fed can successfully orchestrate a soft landing is an open debate. All we know is that the banking system would welcome a soft landing with open arms.

Soft landing or not, it's hard to imagine how the banking sector will come out of the next few years unscathed. Commercial real estate buildings are simply worth less than they were during the period of zero rates. That means there will likely be a downturn for commercial real estate—and banks are likely to take write-downs on their loan books. We're not expecting a banking panic on the scale of the Global Financial Crisis, but it seems highly likely that there will be pain in the sector. It's also worth noting that real estate downturns can take years to play out, since lenders often delay the pain through mitigation strategies such as extending and pretending.

As we head into 2024, we have one eye on interest rates and the other on the economy. If we see the soft landing that everyone's been waiting for and the Fed brings down rates in an orderly fashion, then things may finally start to slowly die down. But if interest rates stay higher for too long, we may start to see another round of turmoil for the banking sector as the commercial real estate trouble plays out. In that type of scenario, the stocks that make up the **SPDR S&P Regional Banking ETF** (NYSE: KRE) might be in line for fresh multi-year lows, sparking questions about the banking sector all over again. Based on the nature of their loan portfolios and exposure to commercial real estate, the smaller banks would be in bigger trouble.

Disclosures:

Certain funds and investment products/services managed by 1623 Capital LLC ("1623") or any of its affiliates may hold shares of JPMorgan Chase, Bank of America, or the SPDR S&P Regional Banking ETF. The mention of any specific securities does not constitute any intent to buy or sell such company nor any inference of a recommendation thereto. Rather, the discussion of these companies is solely intended to illustrate the trailing performance of various stocks, sectors, and indexes, and/or highlight current news with regards to these companies.

This white paper is intended for informational purposes only, and should not be deemed as investment advice or a recommendation to purchase or sell any specific security. This information reflects the opinions, estimates and projections of 1623 as of the date of publication, which are subject to change without notice. We do not represent that any opinion, estimate or projection will be realized. While we believe this information to be reliable, no representation or warranty is made concerning its accuracy. Should you need personal financial advice, we encourage you to speak with a qualified professional regarding all personal finance issues.

Note that past performance and trends do not guarantee future results. Additionally, forward-looking statements—statements that speculate future outcomes based on current and/or past data—involve risks and uncertainties and do no guarantee any particular results. Actual results may materially differ from any expectations, projections, market outlooks, estimates, or predictions ("Predictions") made or implicated in such forward-looking statements. Predictions are not, nor should they be construed as, indicative of the actual results that will occur.

THIS WHITE PAPER DOES NOT CONSTITUTE AN OFFER TO SELL OR THE SOLICITATION OF AN OFFER TO BUY ANY INTERESTS IN ANY FUNDS MANAGED BY 1623. All references to the funds we manage are subject to and qualified in their entirety by reference to information appearing in their respective Offering Memoranda, and offers are made exclusively on the terms contained in the Offering Memoranda. All securities are offered by TMF Investments LLC ("TMFI"), a registered broker-dealer, member FINRA and SIPC, located at 2000 Duke Street, Alexandria, Virginia 22314. TMFI is an affiliate of 1623 Capital.

IMPORTANT RISK INFORMATION. All investments involve risk, including loss of initial investment. The investments and strategies offered by 1623 may not be suitable for all investors. Our funds are speculative and may use leverage and as a result their returns may be volatile. The investment strategies may involve short selling, which may result in substantial loss if securities that are sold short appreciate in value. There is no assurance that the funds' objectives will be achieved or that any investment in our funds will be successful. 1623 Pro Fund II operates as a "parallel" fund, meaning it will invest alongside other funds managed by 1623 that follow the same strategy. Conflicts of interest may arise in connection with decisions made by 1623, including with respect to the nature, structuring and/or timing of portfolio investments, that may be more beneficial to the other funds. 1623's allocation of portfolio investments among the parallel fund and other funds may not, and often will not, result in proportional allocations among the Fund and other funds, and such allocations will necessarily be more or less advantageous to the Fund relative to the other funds. There can be no assurance that the parallel fund and other funds will make or dispose of portfolio investments at the exact same time or on exactly the same terms. The specific risks and conflicts of interest are explained in each fund's Offering Memoranda, which you should carefully read. The deduction of a management and performance fees and expenses reduce an investor's return. Past performance does not guarantee future results.

1623, an affiliate of The Motley Fool ("TMF"), is an investment adviser registered with the U.S. Securities and Exchange Commission. 1623 is a separate entity, and all investment advisory services are provided independently by the asset managers at 1623. No TMF analysts are involved in the investment decision-making or daily operations of 1623.