Banks Have Investors Feeling Déjà vu All Over Again

Adam Bass (00:03):

This is MSCI Perspectives, your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass, and today is March 23rd, 2023.

(00:20):

The last couple of weeks have been, oh, I don't know, rocky, unsettling, nail biting, or maybe best just to stick with the good old fashioned volatile. As I'm sure everyone listening knows all too well, it all started with a run on Silicon Valley Bank, which primarily served the tech industry. Since then, names like Signature, Credit Suisse and First Republic have all flashed across our newsfeeds. And in the midst of all this, the ECB and the Fed held their regular meetings. Thankfully we have access to MSCI's deep bench of experts to help put this all into context. We sat down earlier this week with three of them, Andy Sparks, who heads portfolio management research at MSCI. Jim Costello, Chief Economist for Real Assets at MSCI. And Florian Sommer who heads MSCI's corporate governance research in Europe.

(01:26):

One note before we dive in, since recording our conversation on Tuesday, the Fed announced a 25 basis point or quarter percentage point hike to the federal funds rate. Addressing the elephant in the room, they noted, "The US banking system is sound and resilient." However, they seem to soften their stance on the inevitability of, and again, I'm quoting, "Ongoing increases." All right, let's get to it. I'll see you on the other side.

(02:01):

So Andy, Jim, Florian, welcome to the program. Really great to have all three of you here and have the chance for you three to speak with each other on this important issue. So let's dive in. Our goal here, if I may, would be to help investors not only understand what happened, but also the questions they should ask as they make decisions around their portfolios going forward. And speaking of those questions, my guess is that the question on everybody's mind that I'd love to kick off with is, is this 2008 all over again. Andy, start with you.

Andy Sparks (02:44):

This is a, of course, the concern that many investors are now grappling with. And in this case, we had a trigger event. In other words, a run on deposits that apparently exposed more

fundamental problems with certain financial institutions. Rollback to 2008, Lehman Brothers failed, that generated the global financial crisis. But let's also remember that Bear Stearns failed about six months earlier and at the time it looked like the regulators acted prudently in arranging the wind down a bear. And over the next couple of months, markets seemed to calm, credit spreads tightened. In retrospect, I think everyone would agree that regulators and investors failed to anticipate that Bear's problems were not isolated, but in fact were present in other large financial institutions. So I think one of the big fears in the current environment is that the problems may not go away, but they may reappear in even much more forceful form months from now. The problems that SVB and Signature and Credit Suisse and other institutions that have been in the news lately that these problems are not isolated but could spread, although not necessarily immediately.

Adam Bass (04:10):

What do you think, Jim?

Jim Costello (04:12):

That question Adam, is this 2008 all over again? That's normal human behavior to think about a crisis and how it relates to the last bad event. We're always fighting the last war. But what I like about the way Andy outlined these issues and you got the scenario of is it like Bear Stearns, they clean it up and then nothing else happens? Or is it just the highlight to something bigger? I like that scenario analysis. Think about not just every downturn is the same. Think about what's driving it and how it's different and how it's the same and pull apart the pieces. And one thing that's different than before, than 2008, we don't have lots of toxic loans that people were originating. That's not the fundamental issue here. It was about the reevaluation of assets that these institutions were holding on their books and how they manage their risk around that.

(05:13):

So in that respect, if you go through the different scenarios and think about it from that perspective, maybe it's a different outcome. You have to just think beyond, oh, it's a downturn. It's like last one, different characteristics going in. So you have to expect some different results moving forward.

Adam Bass (05:32):

Florian?

Florian Sommer (05:33):

So what I would say is that, I think in these kinds of cases, going back to 2008 and also now with these recent failures and bank rescues, I think it's normal and it's important for people to ask about corporate governance. And that's because corporate governance is effectively the system used to make company decisions. So to decide strategy and to monitor its

implementation. So if a bank fails or needs to be rescued, people naturally want to know about the decisions that have been made at the company to get to that point.

Adam Bass (06:02):

Sticking with the 2008 theme for a moment, another similarity outside of the banks here is the tie in with real estate, which of course was a huge, was the driver in 2008.

Jim Costello (06:16):

Yeah, the driver in 2008 was the single family residential sector. You had a mass of construction, we needed about 1 million housing units per year to be built, we were building about 2 million per year. And people were getting loans where the bank was behind 95% plus of the purchase. Think of Silicon Valley Bank. One of the issues was about a third of their interest income came from their holding mortgage backed securities. They didn't originate those which just they had deposits and everything else. They had to invest in something to give them some yield. Those mortgage backed securities, the value has been falling as interest rates increased. It was a so-called safe asset, it was a steady credit type of thing, but the reevaluation of the assets on their balance sheet, that's where the problem is. So real estate's impacting it, but in a different way.

Adam Bass (07:14):

Help me understand, and maybe this is a little naive, but typically don't hire interest rates, isn't that usually good news for banks?

Jim Costello (07:22):

Banks make a living by the differences, the spread. The borrow short term, but very low rates and lend long term. So anytime you have a difference in that because of interest rate rising, they can make more money. The problem is that they have existing assets that are tied to a low interest rate environment and this transition is a painful experience for everybody. And part of the issue is just changes in what it is to be a bank. The last time the Fed raised the Fed funds rate, the sharply was back in the early 1970s, financial institutions were different animals then. You originated loans, you held loans. There wasn't something like the mortgage backed securities market that banks could hold on their balance sheet. They could hold cash, they could hold government bonds, but they didn't have as many innovative financial products that they themselves could work with. So this is a bit of what economists call an out of sample analysis. There are things that are happening that are outside of the historical interactions in the data.

Andy Sparks (08:33):

And Adam, coming back to 2008 and what may be different now versus then and what were also lessons learned, I completely agree with Jim that a lot of the problem back then was asset deterioration concentrated in real estate. That was one of the driving problems. I'd also say leverage was very, very large in the system. This was the time of synthetic CDOs, all sorts

of explicit as well as implicit leverage was in the system. And in the aftermath of all of that, of course there was a huge amount of new banking regulation that was implemented including the Dodd-Frank rule. And this has been the first, I don't even want to call the current situation a crisis. It's nothing like the global financial crisis yet. But this has been a test about whether the new regulations that were implemented in the aftermath of 2008, how effective they've been.

(09:40):

And I'd say the early returns are not very effective. And it does come back somewhat to the issue of governance. In modern day banking, banks are not supposed to be taking a lot of interest rate risk and reading various media reports, it does seem that in some of these institutions there was an interest rate mismatch between the short duration deposits institutions were funding themselves with versus the assets they were investing in. And so that is, I think raises a very important question about how effective has regulation been in reality. These problems did exist seemingly without having too much scrutiny. I think it is disconcerting to a lot of investors and it comes back to the potential opaqueness of bank balance sheets.

Adam Bass (10:36):

It does look like from articles now in a number of publications, including the journal that the Fed actually did in the case of Silicon Valley Bank as early as I think 2021 come to them with some issues that they saw. So Florian turn to you. Again, does this come down to governance?

Florian Sommer (10:58):

Thanks for that question. To reiterate what I said before, I think it's very important to think about governance in this context because of the importance to company strategy and companies decisions generally. Board oversight of risk management is a key concept I think for investors to look at. And so what I can highlight here a little bit is how we at MSC research think about board oversight of risk management. And the way we actually look at it is by thinking about what the skills of directors are on the board. So the key question here that we pose is whether companies have at least one non-executive director with risk management expertise. And if that's not the case, we highlight it as a potential risk under our methodology. The question now of course is what counts as risk management expertise? There's different definitions out there and we have our own which is actually quite focused.

(11:59):

And so what counts for us is previous risk management experience as an executive. For example, as a risk officer or other executive functions. So what I did was I looked a little bit at this question for a universe of companies. So for companies in the MSCI world index, so large and midcap companies in developed markets. And it turns out that applying our criteria, we actually find that over 70% of all companies across industries do not have any non-executive director with this sort of expertise. And for banks in particular, I can also share some

numbers. So in this universe we have 74 banks based on our analysis, about one third of banks in the MSCI world index do not have any non-executive director with this expertise, which I think is quite a stark number. So if you're thinking about the centrality of risk management to the business of banking and then the role of the board in overseeing these processes, I think that's a key question to ask for investors.

Adam Bass (13:07):

And certainly risk management, that's what banks are about. Looking across the world as you did, did you see any regional differences in terms of these numbers?

Florian Sommer (13:20):

Yeah, that's another great question. So I think one comparison that I can share is between banks in the US and non-US based banks. And so if you look at that, we have 24% of US banks for lack of director risk management expertise. And that compares with 35% per non-US banks. You have a higher share of risk experts on the boards of US banks in this sample.

Adam Bass (13:51):

Andy and Jim, you both raised this, the idea of data of transparency about the fact that so much of what we're looking at here is opaque. Is that part of the problem? And if it is, what can we do about it?

Andy Sparks (14:07):

There's going to be plenty of finger pointing and of course it's already started. First and foremost, banking regulators are supposed to have various trip wires that anticipate potential problems that result in a satisfactory resolution well before the situation escalates. So that didn't really happen here. The failure of bank regulation to prevent the current situation is going to be one of the key issues going forward. But fundamentally, the case of SVB, it was a pretty large institution. It was regulated by among other regulators, the Federal Reserve. And it does seem like there was a basic failure to anticipate these problems even though seemingly the Federal Reserve, for example, seemed to have some advanced knowledge of looming problems.

Jim Costello (15:06):

And on this issue of opaqueness, in the US, the regulators do have an ability to get some information about each of the institutions that they're regulating in the banking side. And I deal a lot with the commercial real estate world. There's a whole universe of lenders outside of the commercial real estate side. There's a whole securitized world that's very transparent because it comes under a lot of FEC type regulations. Stuff outside of that, private loans, debt funds, doing stuff like that. Very opaque because it's just individuals without any regulatory oversight except some URISA stuff when they're raising capital that oversees them. But that's in the United States. Other parts of the world, there are different regulatory frameworks and not as much information available. It's a sector that's still very much something that a clubby

network of people talking to each other at conferences to get a sense of market pricing because you just don't have daily rates published in many cases.

Andy Sparks (16:16):

I don't want to let investors completely off the hook here either. Skeptics of bank regulation could also argue that excessive bank regulation and even intervention has created this moral hazard that has reduced the discipline of the market. And so under this line of reasoning, investors have maybe placed too much faith in the regulators and not enough in their due diligence. So I think it's also important to underscore that obviously a lot of investors are taking big hits and it's easy to say after the fact, hey, they should have paid more attention to this and that. But ultimately this is what used to be known as the Greenspan put and then became the Bernanke put and the Yellen put, and maybe now it's the Powell put. This idea that the banking regulators, because they have periodically helped bail out feeling institutions and maybe lessened the pain to investors as maybe encouraged excessive exposure to the banking system from investors because of this view that central banks will intervene.

Adam Bass (17:27):

But given the opaqueness that we were talking about, I hear what you're saying about investors, but how are they supposed to make decisions if they don't have the data?

Andy Sparks (17:36):

Well, there's always data and the question is how much effort do you want to invest in doing more and more analysis? And so look, the banking sector is very well covered by equity analysts, by fixed income analysts. So there's a tremendous amount of focus on it.

Florian Sommer (17:56):

I think I can bring it back to the question of risk management. So the role of the board in overseeing a company's risk management is obviously a role that has different facets to it. And part of that is making sure that the right policies and procedures are in place, but that also includes having the right type of information come up to the board.

Adam Bass (18:22):

So as we're having this conversation, we're on day one of the federal reserve meetings here in the US. Obviously this will have an impact. Andy, I'll start with you as our resident historian and scholar on the Fed. Give us some insight, what do you think those conversations are like?

Florian Sommer (18:47):

Well, needless to say, fixed income markets have reacted very strongly to the recent turn of events. Yield curves have dramatically steepened in anticipation of much less aggressive rate hikes going forward. Markets in interest rate futures showing expectation that the Fed will be lowering rates by mid-summer. Credit spreads have widened significantly and market implied

inflation expectations have noticeably declined just over the past few weeks as the current banking situation plays out. So this is all consistent with the view that the current banking situation is going to curb lending activity and effectively to help the Fed cool the economy in lower inflation. So I think a lot of the focus at the needing is going to be how much more do we really need to raise after this extended period of very aggressive rate hikes? Is this banking crisis effectively going to be helping us out and lessening the load that we have to drive rates higher to cool the economy that may be less necessary given potential tightening for in lending activity in a cooling of the economy.

Jim Costello (20:11):

From the perspective of commercial real estate, this raising of rates and the cooling off, it was cooling off both on the supply and the demand side. The number of unique lenders each month had been falling through the fourth quarter of 2022. Well before any of it's not a crisis, maybe it's a kerfuffle, we'll call it that, has started because the opportunity set that they saw was falling for both the lenders and the potential borrowers. Liquidity was drying up that way. The originators were tightening the standards at which they would originate. So all that was a backdrop before we even hit this kerfuffle. And so this situation is just exacerbating it. The challenge I think they have that they go too hot or too cold now that you don't want to have all the legs of the stool for financing dry up because then you do end up in the 2008 type of framework where even high quality borrowers can't get money at any price and they're not going to make everybody happy. It's a no win situation for them in that sense.

(21:24):

And we know that the Kobayashi Maru scenario, the only way to win is just know that you're going to lose and you're not going to get everything you want, but just stick to your principles. And stick to your principles and focus on that, and that's the best way to get through it.

Adam Bass (21:43):

How have investors been reacting to the response that we've seen from the Fed in terms of backing deposits, the Credit Suisse situation with the government backed or engineered, we can choose our word with UBS coming in to purchase and big impact on debt there as well as some other governance issues we can talk about. But how has the market been reacting to all of this action by government and central banks

Andy Sparks (22:15):

Say so far it's been calming. When the initial news went out about SVB and Signature and other regional banks and Credit Suisse, there's a, of course a sharp selloff in the equity market, sharp rally, a flight to quality rally into government bonds, credit spread, some widening at the same time. So very vicious reaction. But since these interventions, there has been a calming influence. And I think the real question for investors is that, is this going to be temporary or we A, going to revert back to this the situation before these recent events, or could it further escalate potentially in a few months into something worse as Lehman did evolve after or and did occur after the Bear Stearns takeover.

Jim Costello (23:22):

Thinking about this issue from the perspective of the investors in the banks is one way. Thinking about it from the perspective of the users of the banks, the borrowers who would go to them looking for capital. I've been up to my ears in the last a week thinking about the real estate investors and how they were using debt from institutions. The smaller lenders are dead center for some of the challenges and concerns at the moment. And that's an issue because those regional local banks had been growing as a share of all lending to commercial real estate over the last 10 years, and they were the majority lender as of the end of 2022. They're going to be like 27% of the market for all commercial real estate financing. So there's a number of folks in that commercial real estate investment world concerned about what types of investment opportunities they will face moving forward. And in that they need a lot of debt to make these investments work, traditionally they have. And do they face some future liquidity constraints that will impact pricing?

(24:34):

So it's a circular issue of people worried about the value of the assets on the book for the lenders, but then the borrowers are issuing things that they themselves hold. So there's the potential for a downward spiral there that people are worried about.

Andy Sparks (24:54):

Adam, I'd also like to say, the reality is that, over the past number of years, we generally have had a really, really low interest rate environment for quite a while and we had relatively low inflation. This is up until a couple of years ago, of course. And we may be in a different regime going forward. Maybe in terms of real estate, maybe it's not as big a concern now as 2008, but think other things like crypto and what is the exposure to crypto. And maybe it's less than an investors think, maybe it's more who knows. But there are some new elements that investors should be thinking about. And it comes back to opaqueness of balance sheets and from an investor's perspective, trying to better understand what risks do lurk out there, particularly among financial institutions. History suggests that you have generally these trigger events at banks. It could be a run on deposits, but the combination of interest rate risk, credit risk, liquidity, risk and leverage, it's usually some combination of those that creates a crisis.

Adam Bass (26:24):

Great points, as you've all made about this is bigger than banks, this is bigger than fixed income, it's bigger than real estate. It's looking at your total portfolio. So with that in mind, anyone please jump in first for an investor, what are they looking for? What should they be on the lookout for in terms of having the information they need to make decisions about those portfolios under the different scenarios that Andy, you were talking about?

Andy Sparks (26:56):

Well, I'll start. I think the first thing is to understand how their portfolios and how individual securities in those portfolios might behave in different scenarios. And so we may not know

the probability of one scenario versus the other, but most investors will have some sense that there are maybe three or four different scenarios that are likely to happen but could have very different outcomes, but they may not have a way of quantifying what would be the impact on the portfolio if this were to occur. And so I think finding tools that will help them with that, I think is important. So identifying the scenarios, and we oftentimes find working at MSCI with institutions who are looking at portfolios under different scenarios, that it's very healthy within the institution to have sometimes a vigorous debate about plausible scenarios. It oftentimes brings different parts of an institution on the same page. And so once you've identified those scenarios, then the next thing you need to do is to make some basic assumptions and then to use some risk management tools to better understand how in each of those scenarios the portfolios will behave.

Jim Costello (28:21):

It's funny when I think about this, you have this talk about portfolios and risk and it's a very institutional way that people talk about it and very reserved. There's some clients I deal with who are not reserved at all, they're cowboys and they are excited. They're excited by this because they smell blood in the water. They think this is interesting. And there's folks looking at this as an opportunity. There have been periods in the past where we've run into a crisis situation and the people who come in and clean up whatever messes are around afterwards tend to do well. They get compensated for the risk that they take to clean it all up. But they are excited for some of those opportunities. The types of things that they're trying to figure out are who is too far ahead of their skis, whether it's trying to dig into the details of each lender and figure out the relative balance sheet or trying to figure out which borrowers were coming in at prices that were too high and in an unsustainable framework and maybe who has a loan come and do in the next two years.

(29:38):

And so folks are trying to pick apart all our information to get at that.

Andy Sparks (29:42):

Very well said, Jim. And that reminds me of, again, but by the way, full disclosure, I did work at Lehman Brothers for many years and I was there during the bankruptcy, so some of this still is pretty fresh in my mind. B

Adam Bass (30:01):

Sorry for triggering.

Jim Costello (30:02):

Keeping you leaving swag though?

Andy Sparks (30:06):

Oh, of course. Yes, I do. I do have my souvenir still and I do wear them ever so often. But I do know, and I do have a background in securitized products and I know plenty of traders and structures who helped structure subprime CMOs, a lot of other structured products and a lot of those products performed very, very poorly at the depth of the crisis. But quite a few of those traders went on to after the institution failed, in this case, Lehman, they went on to other jobs, maybe at hedge funds. And a lot of them bought those securities that they'd structured at very low prices and made quite a bit of money. So I think what you said, Jim, is very well taken. That distress does create opportunities too. And of course there are many a aggressive investors out there who are bottom fishing now.

Florian Sommer (31:09):

I also really like that framing, never let a good crisis go to waste. So I think from a portfolio perspective, one thing to maybe potentially think about is trying to see how companies are now positioned in terms of their governance to deal with some of the risks that we're seeing with some of the increased market volatility. And we talked about risk management expertise on the board, that's a key issue. But there's other things that we can think about as well in this context. And I'm just going to mention one that is relevant for banks, but also for non-banks. I think especially in this environment. And that's over boarding, director over boarding. It's not necessarily a pretty term, but essentially what it means is that, if you have an over boarded director that's a director who sits on too many boards. So the potential risk there is that in an environment where you might want to have directors spending more time making decisions, scrutinizing proposals by management, you might have over boarded directors that have so many other commitments and that might impact their ability to focus on any particular company.

Adam Bass (32:20):

Fair point, excellent points all around. Thank you again, Andy, Jim, and Florian for joining us and for really a great conversation. That's all for this week. A big thank you from Joe, Phil and me to Andy, Jim and Florian and all of you for listening. You can always stay up to date with MSCI's latest market insights at msci.com. Next up on the program, it's our quarterly check-in where we'll put markets in focus with Hitendra Varsani and Mark Carver. Until then, I'm your host Adam Bass, and this is MSCI perspectives. Stay safe, everyone.

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