

Spectrum Asset Management

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Regional banks: Crisis of confidence, not credit

Spectrum remains constructive on the regional bank space despite negative market sentiment.

The prospect of further bank runs underscored by negative messaging and short selling ignores the industry's positives, in our opinion. Another contributing factor is the absence of government leadership. The U.S. should "do whatever it takes" to help these banks. Unlike during the Global Financial Crisis, the issue is primarily liquidity caused by deposit outflows, exacerbated by negative market sentiment, not credit. One option might be to modify the uptick rule to further limit or reduce short selling in depository banks from current regulations. Another might be to increase the amount of FDIC insurance for individual depositors in regional banks in order to calm fears and reduce the deposit flight being seen in the market.

Stable fundamentals of the regional banks include:

- Sound management
- Good asset quality – low level of non-performing loans as a percentage of assets
- Strong capital
- Solid banking footprints
- Slowing deposit outflows (other than when market volatility fans the flames)
- Continued profit generation, though slowed by lower income and rising deposit costs

The issues facing regional (and most other) U.S. banks are not loan quality or capital-related, but of general bank confidence given two highly visible regional bank failures, and effects of higher interest rates. We emphasize that bank securities portfolios are of high quality, though market values have been diminished due to higher rates. We believe this will correct itself as those holdings march towards maturity. We also note there are additional stopgap measures including liquidity support for all banks through the Federal Reserve's new Bank Term Funding Program. Meanwhile, mergers between regionals could help to create scale against higher operational and regulatory costs.

There should be more action at the governmental level to allay market fears including congressional actions to increase deposit insurance and reduce short selling of the regionals. This must happen sooner rather than later.

The regional banks are important to local communities and depositors. While market jitters about further receiverships are self-fulfilling at the moment, Spectrum emphasizes that existing fundamental headwinds to the otherwise stable regional banking sector are an earnings story and not a credit story.

Joe Urciuoli, Head of Research

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