Credit Update: A Storm Watch…Not a Warning

March 31, 2023

The recent and sudden panic-driven banking crisis is not the same as the Global Financial Crisis (GFC) of 2007-2008. While the current environment has echoes of the GFC, in our opinion, current events are substantially different. The GFC was caused largely by loose lending standards, particularly in the mortgage industry. Subprime and other lower quality loans and securities lost value rapidly. The decreases in valuations resulted in large losses and depleted capital at banks around the globe. At the peak of the GFC, investors and depositors fled a number of prominent banks, resulting in their bankruptcy or closure. In subsequent years, many more banks were closed by regulators as the financial crises led to a deep downturn in real estate prices and a recession.

Declining securities prices are a commonality between recent events and those of the GFC. However, the causes of securities price declines are far different between the two periods. During the GFC, low-quality securities declined in price due to investors' concerns about possible default. This contrasts with 2022 when the Federal Reserve and other central banks increased interest rates rapidly to combat inflation, which placed downward pressure on all securities prices. High-quality U.S. Treasury and mortgage-backed securities, which comprise a large portion of bank balance sheets, declined in price substantially. We believe the different causes of securities price declines will lessen the impact on most banks in the current environment compared to the credit concerns which resulted in the GFC.

Recent Banking Industry Stress

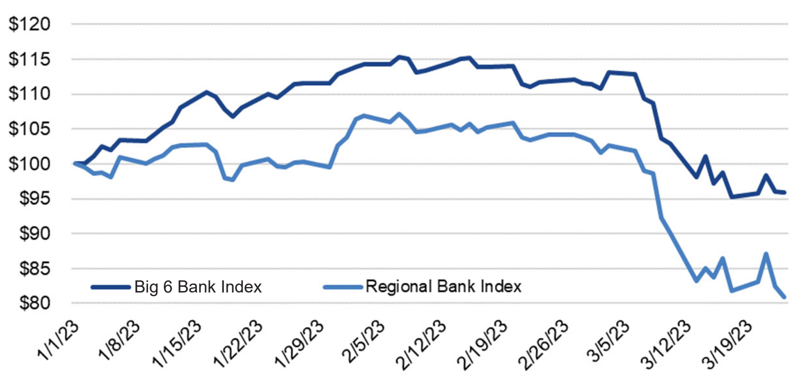
The Federal Reserve's tighter monetary policy over the past year has impacted the U.S. banking industry in myriad ways. First, rising rates have put downward pressure on market values of banks' securities holdings. Second, the Fed's policies have reduced total reserves in the banking system. These factors and others led to a modern version of an old-fashioned run on the bank for Silicon Valley Bank. *Quick and decisive action by bank regulators stemmed panic selling of deposits at other banks and prevented what could have been a broader banking and financial crisis.*

In the case of Silicon Valley Bank, a perfect storm of circumstances collided with the broader industry factors described above. As has been well-publicized, Silicon Valley Bank had a concentration in deposits to technology companies and startups with ties to venture capital. Tighter financial conditions reduced access to venture capital and caused the companies to draw down existing cash at the bank to run their businesses. The deposit withdrawals caused Silicon Valley Bank to sell securities at a loss, depleting capital. When Silicon Valley Bank's parent holding company announced plans to raise capital, the closely connected group of technology companies, fueled by social media, began rapidly withdrawing deposits.

The panic related to Silicon Valley Bank quickly began to spill over into the broader regional banking sector. Some customers of smaller banks moved deposits to larger "too big to fail" banks and money market funds. Additional information will be known about the extent of deposit withdrawal activity from individual banks when first quarter regulatory filings are released in April. These reports could exacerbate problems for certain banks and we view this as a time for depositors to exhibit caution. This provides the potential for another financial markets disruption, but in our opinion, the current environment generally lacks weakness in credit quality that is normally associated with a financial crisis. *Unlike the GFC, current banking industry asset quality remains very good and recent events appear more isolated.* As such, we see a storm watch rather than a warning.

In response to the panic, the Federal Reserve expanded access to the discount window and announced a new facility called the Bank Term Funding Program, which allows banks to meet depositors' demands without needing to liquidate bond portfolios below their par values. These steps were taken to restore confidence that bank deposits are safe and to reduce the risk of additional bank deposit runs. This helped calm depositors, however, the KBW Regional Banking Index has fallen by nearly 20% since the beginning of the year. This compares to an index of the six largest U.S. banks, which has declined by a much smaller degree. The difference indicates investors still have concerns about potential issues at smaller, regional banks.

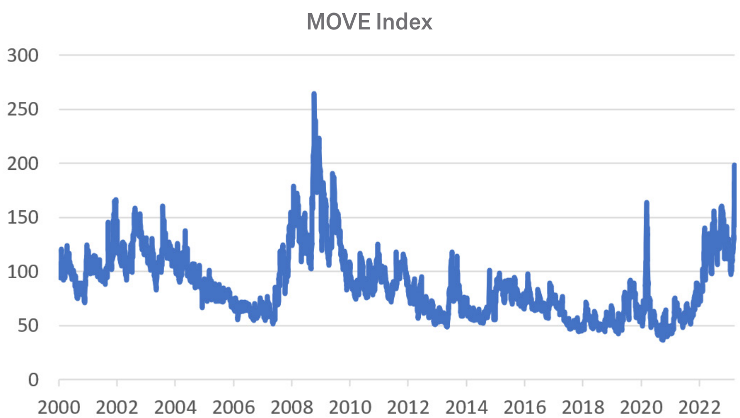
Big 6 Banks vs Regional Banks
Return of $100



Source: Bloomberg and PMA Asset Management. Data as of 03/23/23.
Big 6 Banks represented by an equal weight exposure to Bank of America, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley and Wells Fargo. Regional Bank Index represented by the KBW Regional Banking Index.

Broader Market Turmoil

Uncertainty around another global financial crisis has sent valuation ripples throughout the markets. The recent uptick in volatility has been noticeable across nearly all asset classes and most exaggerated in the typically calm fixed income market. The MOVE Index, a measure of bond volatility, spiked from its trailing twelve month low of 97 on February 1st to 199 on March 15th. For context, the index hit 195 during the Dot Com Bubble, 264 in the Global Financial Crisis, and 164 when Covid-19 entered the United States. Also during March, Swiss banking regulators backstopped Credit Suisse and eventually brokered a deal for the failing bank to be acquired by another Swiss bank, UBS.



Source: Bloomberg

These market moves and developments are more akin to waves than ripples. This returns us to the question of whether a storm is brewing or has arrived. At PMA, our analysis shows that aside from outliers such as Credit Suisse, banks are more profitable and far better capitalized as the result of more stringent regulations that followed the Global Financial Crisis. Nonetheless, it is a time to be extra vigilant about credit quality and collateral.

PMA Risk Management

The recent market stress has been a reminder of why PMA employs multiple layers of risk management in its investment process. While the creditworthiness of the banking system and institutions in PMA's network is sound in our opinion, a bank run on deposits highlights the importance of collateral and insurance protections. *FDIC insurance and collateral provide protection from risk, including those risks that can't be foreseen or modeled such as market panic.*

PMA's Credit Team monitors the credit quality and collateral of all client investments on an ongoing basis. Collateral monitoring and risk management include determining the market value of pledged securities collateral and employing systems to ensure that client deposits do not exceed pledged collateral and insurance. In addition, PMA's Credit Team utilizes fundamental credit analysis including quantitative and qualitative analysis to determine the creditworthiness of each depository prior to facilitating the investment of client funds.

During this period of elevated market stress and volatility, PMA is collaborating across our teams to bring forth all resources in evaluating an evolving situation. Utilizing our credit team, bank funding team, equity team and seasoned investment professionals to gather and review real time updates. We anticipate market volatility to continue as markets and the economy progress through this period of high interest rates and inflation. Be assured that PMA continues to be committed to prioritize safety, liquidity, and yield, in that order, to keep your investments safe.

Credit Team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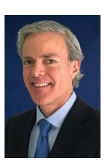
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