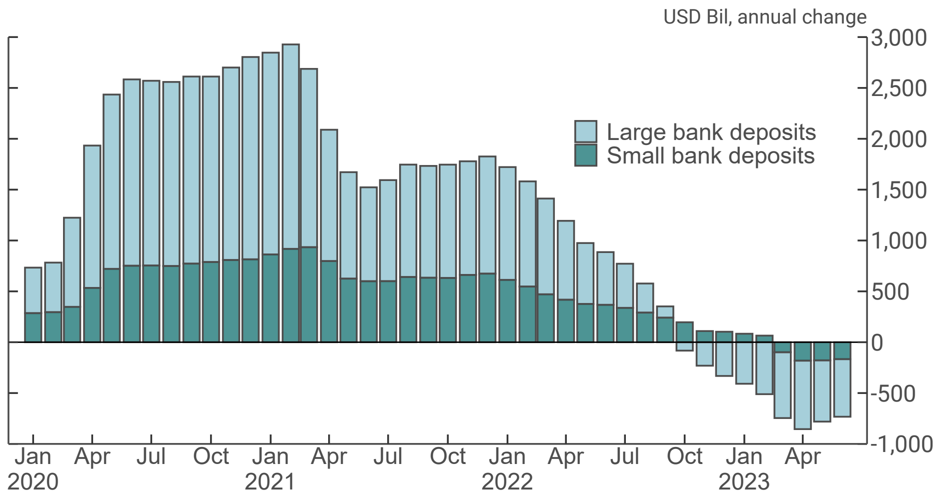
BOX 1. REGIONAL BANK DEVELOPMENTS

The US banking system continued to feel the mild tremors from market turmoil that began in the first quarter with the collapse of Silicon Valley Bank (SVB) and Signature Bank. In April, despite efforts from eleven major banks to assuage fears by injecting $30 billion in deposits, San Francisco-based First Republic also fell victim to a run by uninsured depositors. Several more regional banks have since experienced severe pressure.

There are signs that things are stabilizing, but regional lenders will face an uphill battle as higher rates and the liquidity crunch will put further pressure on margins. While these lenders saw some reprieve after the Fed's June stress test showed midsized lenders maintained capital levels above required levels, the KBW Regional Bank Index plunged 6.7% over Q2, reaching a YTD loss of 22%.

Figure 1.1 Banks deposit outflows continue at a steady pace



Source: Federal Reserve Board, Statistical Release H.8, "Assets and Liabilities of Commercial Banks in the United States (Weekly)."

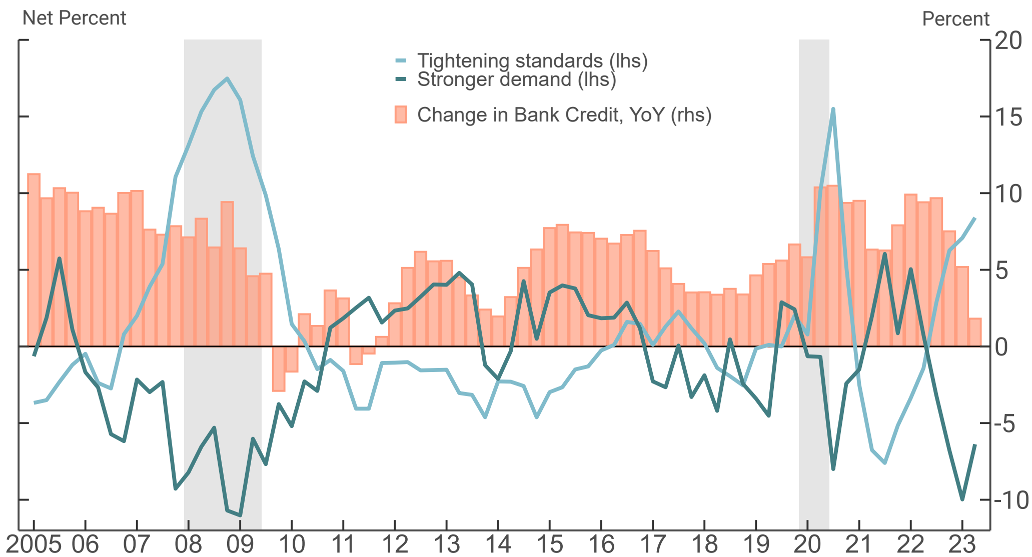
Even as the dust settles from the recent government interventions, these lenders face underlying problems. Banks were already experiencing deposit outflows late last year as depositors searched for higher yields. The events in March merely accelerated the trend. They are also tightening credit standards and borrower demand is waning as funding costs grow. At the same time, rising rates are deepening losses on banks' balance sheets, raising concerns that banks will need to sell assets at a loss to cover the heightened demand for cash. Losses on the loan book are beginning to manifest, particularly on the commercial real estate side, where banks represent nearly 70% of total CRE loans outstanding. They also represent a much higher proportion of regional banking balance sheets, with more than over 40% of total assets in CRE loans.

The landscape for regional banks is poised to undergo a major shift. To overcome the rising costs associated with higher rates and potential new regulatory requirements, these banks will need to

BOX 1 — *continued*

get bigger, making consolidation the most attractive option for these lenders. Merger activity has reached its lowest levels in over a decade, but the recent shakeup will likely lead to a new wave of consolidation. The actual merger process will take some time to play out, but investors see several opportunities in the financials space as bigger banks look to snap up distressed assets at attractive prices and smaller banks restructure.

Figure 1.2 Credit standards are tightening and demand is weakining



Source: Federal Reserve Board, Statistical Release H.8, "Assets and Liabilities of Commercial Banks in the United States (Weekly)"; and Senior Loan Oficer Opinion Survey (SLOOS).