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ISSUES & ANSWERS: ASSET MANAGEMENT

Industry experts discuss the drop in the market value of their insurance investment portfolios, how higher interest rates have affected the industry and how they've noticed more intense migration of deposits out of smaller banks versus larger banks.

Interviewed Inside:

Leah Savageau
AAM

Ken Griffin
Barings

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Bank Failures Spark Concerns

Leah Savageau, a Senior Fixed Income Credit Analyst who covers the banking sector for AAM, said one of the bigger issues she's noticed is more intense migration of deposits out of smaller banks versus larger banks. "In the first week following the closure of Silicon Valley Bank, we saw migration into larger banks, which we presume was a flight to quality response among depositors," she said. Following are excerpts from an interview.

Leah Savageau
Senior Fixed Income Credit Analyst
AAM

"As banks rely more on liquidity and funding sources, it's going to raise their cost of funds and ultimately lead to tighter credit conditions across the United States."

Visit the Issues & Answers section at *bestsreview.ambest.com* to watch an interview with Leah Savageau.

How have the recent bank failures impacted the U.S. banking sector?

The bank failures were driven by liquidity and asset-liability mismatches. The genesis of these failures was Silicon Valley Bank, which catered to venture capital-backed companies. Typically, when there's a crisis of confidence at one bank, it can spread very quickly to other banks with similar characteristics. In this case, depositors and investors became focused on banks with deposits sourced from venture capital backed companies and also those with large amounts of uninsured deposits. This is what happened to Signature Bank, which failed two days after Silicon Valley. As we stand here today, confidence in the regional banking sector remains low, and investors are concerned that certain banks—such as Pacific West and Western Alliance, who also experienced substantial deposit outflows in the wake of the Silicon Valley failure—may also be vulnerable toward being placed into receivership.

What does a banking crisis mean for the U.S. economy?

Since the failure of Silicon Valley Bank, we've been closely watching certain data sets published by the Federal Reserve to get a sense for whether this is truly a crisis or isolated to a small collection of banks. The data suggests that the contagion has so far been limited and that deposit flows on a systemwide basis have been relatively stable. The first data point that we can look to to draw this conclusion is the industry's usage of emergency liquidity programs such as the discount window and the newly established Bank Term Funding Program. Both serve as indicators of funding stress in the banking sector. The key trend that we've observed is that the combined usage of these facilities is down from the peak level immediately following Silicon Valley's failure.

Are U.S. banks still vulnerable, and what have regulators done in response?

Yes, I do think banks are still vulnerable, but I think we're going to start moving away from situations where stresses are caused by acute liquidity issues and asset-liability mismatches. In terms of the response from the regulators, there has yet to be any specific changes announced. The Fed did publish a view of the supervision and regulation of Silicon Valley Bank, and the findings are expected to form the basis for ongoing consideration and rule-making efforts. The report notes that, while the cause of Silicon Valley's failure was a liquidity run, the underlying issue was a concern about its solvency and that the Silicon Valley experience has emphasized why strong bank capital matters. This suggests that regulators will still seek to boost not only liquidity standards, but also capital requirements.

What's in store for the banking sector in the near term?

Things are pretty murky right now. It's encouraging that some of the banks that have been under intense pressure following First Republic's failure reported that their depositors are not fleeing. It's difficult to tell if that will remain the case, especially since equity prices and deposit flows have been operating in a negative feedback loop. If investor sentiment remains poor and those banks continue to see pressure in their equity prices, depositors could get spooked and start withdrawing uninsured deposits. I don't expect the sector to rebound to pre-bank-failure sentiment anytime soon.

Under Pressure

Ken Griffin, Managing Director, Head of Insurance Solutions for Barings, said that while asset market values have declined, so has the market value of their liabilities. "Economically, insurers should be in a reasonable position, if not in a better position, than they were before the rate shocks as reinvestment rates are relatively high for firms that can capture unique opportunities in credit and structured asset classes," he said. Following are excerpts from an interview.

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Ken Griffin
Managing Director, Head of Insurance Solutions
Barings

"There is some uncertainty about the behavior of policyholders in this higher rate environment, which could cause some strain."

Visit the Issues & Answers section at *bestsreview.ambest.com* to watch an interview with Ken Griffin.

What's keeping insurers up at night?

Insurers are under pressure on a number of fronts. Currently, most significant is the rapid increase in interest rates over the past year, which has caused a steep drop in the market value of their insurance investment portfolios. This has many knock-on effects for how they conduct business. There are accounting and capital implications of this, which the industry is in the process of working through. There are also several regulatory changes being proposed, which will create uncertainty for insurers that they'll need to navigate.

How has the changing interest rate environment impacted insurers?

During the low rate environment, insurers often said higher rates would provide welcome relief for ever-compressing profit margins in spread businesses—but just not having higher rates all at once. Unfortunately, this is essentially what's happened with Treasury rates as they've increased quickly, even beyond many of the worst stress scenarios insurers use to test their portfolios. Credit spreads also increased, which has caused a significant increase in the unrealized loss position of the fixed-income portfolios. Insurers typically have prudent risk management approaches in place, so while asset market values have declined, so has the market value of their liabilities.

What are the accounting and capital implications of this environment?

For life insurers, there is an accounting feature that captures realized gains and losses in an interest maintenance reserve (IMR) and this amortizes into income over time. This has worked well through decades as rates have generally fallen, gains have been realized, and IMR has had a positive balance. Unfortunately, there's an antiquated rule in place that does not allow for negative IMR balance to be an admitted asset. So as losses are realized and IMR is depleted, these losses will become a direct hit to surplus, thus giving a false impression that capital adequacy is impaired although economically insurers with proper risk management in place are strong. This can also distort an insurer's ability to rebalance their portfolios to manage risk and can exacerbate liquidity needs as longer liquid bonds can become off-limits to sell.

What are the other regulatory concerns?

From an investment standpoint, there's increased scrutiny by regulators to better understand the growing asset classes for insurers. For instance, CLOs have attracted significant interest from insurers, and regulators are concerned that a capital arbitrage may be taking place there. At origination, a structured CLO may have a lower capital charge than holding the underlying bank loans, but over time, as the higher-rated securities run off, the remaining lower-rated, higher-charge tranches lead to a higher overall capital charge. So needless to say, more analysis is needed before any capital factors are changed, and the NAIC has stated a commitment to doing this evaluation in a transparent way. And today it's perhaps even more important than ever to partner with an experienced team of investment professionals to help navigate these economic, accounting and regulatory issues.