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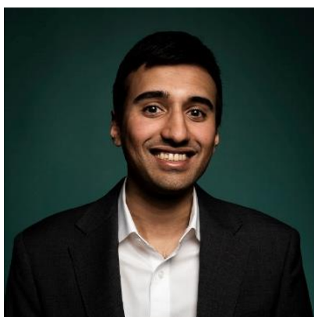

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# Divergence in U.S. Banks: Exploring Resilience in Global Systemically Important Banks (Part I)

This year's turbulence in the banking sector began with the collapse of Silicon Valley Bank in March, setting the stage for subsequent regional bank failures, including notable cases like First Republic. As a result, the three major rating agencies initiated a wave of downgrades during the summer, reigniting concerns about the overall health of the sector. Markets are also bracing for a prolonged period of elevated interest rates. These challenges have introduced a sense of uncertainty, particularly given the contrasting strength of the largest U.S. banks in relation to the conversation about regional banks.

In this dynamic landscape, Global Systemically Important Banks (G-SIBs) have displayed remarkable resilience when contrasted with their smaller counterparts. This piece will delve into the factors underpinning the sustained strength of G-SIBs, examining crucial aspects like tier 1 capital ratios, positive results from the Fed stress tests, and the robustness of their balance sheets. Additionally, the second part of this blog series will explore the potential advantages of investing in their preferred shares over other available investment avenues.

*This discussion is divided into two parts. The first part will focus on the banking sector developments, and the second part will explore investment opportunities as well as why preferred stock may stand out as a compelling option for investors.*

## Key Takeaways

- Recent downgrades to the operating environment, exacerbated by proposed long-term debt (LTD) requirements, may subject the more speculative credits to higher borrowing costs, potentially squeezing profit margins. While G-SIBs are not immune from downgrades, the regulatory risks remain largely isolated to regional banks.
- G-SIBs continue to demonstrate strong capital positions, in excess of thresholds established by regulators over a decade ago. Common equity tier 1 (CET1) capital ratios have remained consistent over the past few recent years, signaling strength amongst the largest, most diversified banks.
- As rating agencies have begun to scrutinize commercial real estate (CRE) exposure, G-SIBs have actively reduced their CRE exposure. Meanwhile, other smaller segments of the banking ecosystem have been increasing their share of the CRE market over the same period, potentially an attempt to mitigate credit risk by the larger banks.

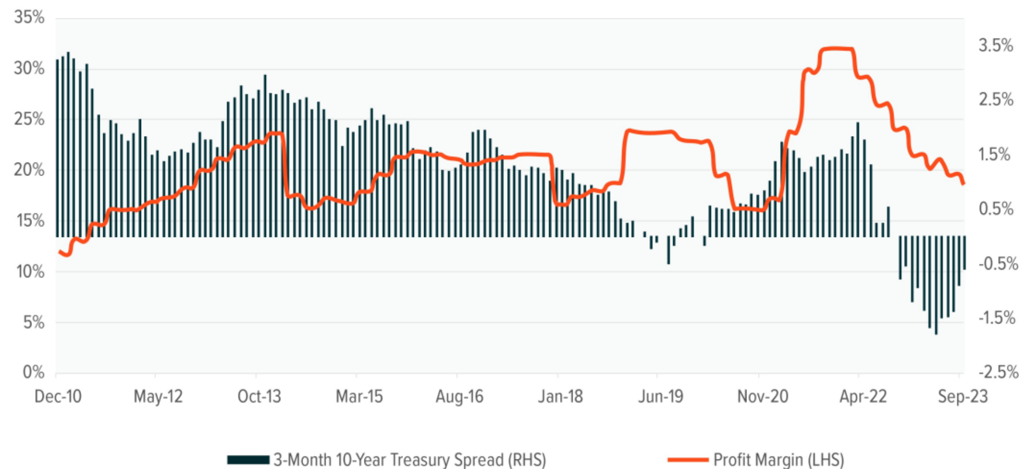
## Effects of Elevated Interest Rates on Bank Profitability

The market and rating agencies have been grappling with the increased likelihood of higher, sustained policy rates for months. As the chart depicts below, higher front-end rates have caused the treasury curve to invert, as represented by the 3-month 10-year spread. This inversion is having an impact on banks' profit margins for two main reasons. The first reason is that banks tend to borrow at short-term rates and lend at long-term rates. The tighter the spread, the more compressed the net interest margin (NIM) becomes, leading to lower profit potential. This can also slow lending activity and have a negative impact on the outlook of economic growth, creating a feedback loop that pushes long-term rates lower. The second reason is that, as alternative savings instruments like money

market funds gain appeal when front-end rates rise, net deposit costs tend to rise in parallel. Banks tend to raise deposit rates to retain deposits, which affects their net interest margins as funding costs rise. Additionally, loans held by banks tend to have a negative correlation with interest rates, potentially causing the asset side of the equation to decline.

## RISING POLICY RATES DAMPEN PROFIT MARGINS FOR U.S. BANKS

Source: Global X ETFs with information derived from: Bloomberg L.P. (n.d.) Data from 12/31/2010 to 10/23/2023. Bank Earnings are represented by the Profit Margin from the MSCI US Banks Index GICS Level 2 Index; 3-Month 10-Year Treasury Spread is represented by the Market Matrix US Sell 3 Month & Buy 10 Year Bond Yield Spread Index.

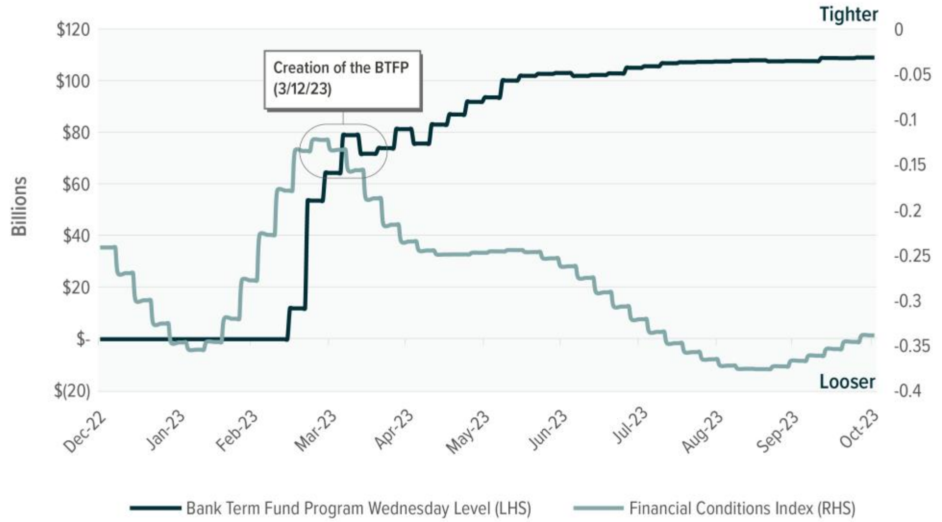



Introduced in March 2023 in the aftermath of the Silicon Valley Bank and Signature Bank failures, the Fed’s Bank Term Funding Program (BTFP) helped mitigate some of these profit concerns.[1] Unlike the more traditional discount window, which values posted collateral on a market-to-market basis, meaning that the collateral is priced at the current trading or market price, the BTFP holds eligible securities at their par value, or the original value amount. This approach effectively mitigates the impact on the asset side when banks need to sell eligible securities to match deposit outflows. Such a measure can play a crucial role in preventing a significant hit to their balance sheets, especially when the assets are designated as "held-to-maturity" and valued at par. In the event that a bank needs to sell a security due to a high level of deposit outflows, this sale can trigger a revaluation of the security to its lower, market-depressed price resulting from higher interest rates, leading to a decline in earnings and potentially further deposit outflows. The BTFP has contributed to reducing contagion and the likelihood of a "bank run" scenario.[2]

The Fed’s new monetary tools helped alleviate tighter financial conditions, as shown below. At the Federal Open Market Committee (FOMC) meeting in September, Chair Jerome Powell reinforced the "higher for longer" narrative, vocalizing that while the end of this hiking cycle is near, borrowing costs must remain at the current elevated level for an extended period due to renewed economic strength.[3,4]

## THE IMPACT OF THE BANK TERM FUND PROGRAM ON PREVENTING EXCESSIVE TIGHTENING OF FINANCIAL CONDITIONS

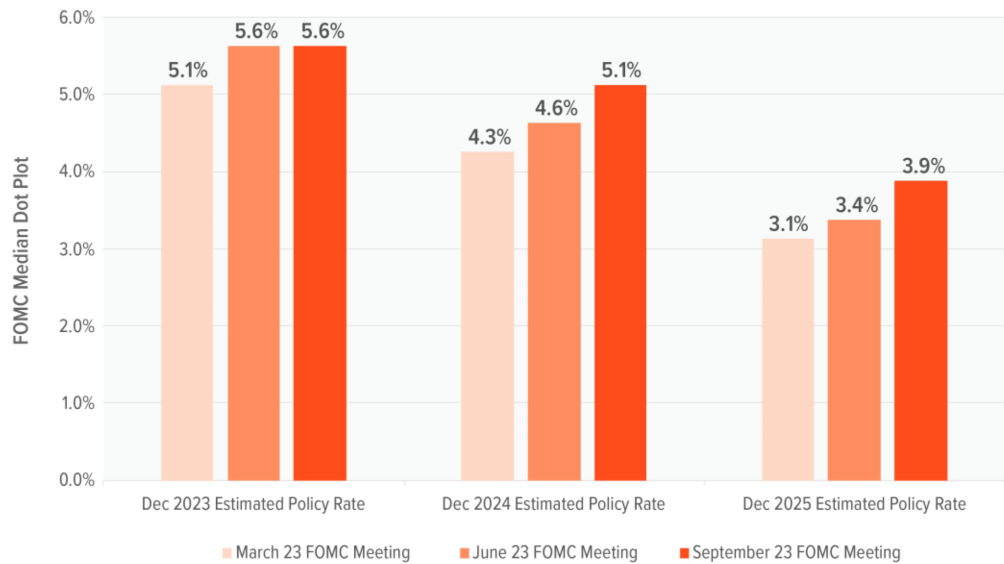
Source: Global X ETFs with information derived from: Bloomberg L.P. (n.d.) Data from 12/31/2022 to 10/31/2023.




The FOMC's median dot plot over the last three projections reinforces this view. Front-end rates remaining elevated may make money market funds and other instruments more attractive for longer periods. The potential for increased deposit outflows from banks most susceptible to a 'bank walk'—a gradual outflow of deposits—is not as concerning to larger depository institutions due to their diversified revenue channels and their ability to maintain tighter deposit rates compared to smaller institutions.

## LATEST FOMC MEDIAN DOT PLOT REFLECTS HIGHER FOR LONGER NARRIVATIVE

Source: Global X ETFs with information derived from: Bloomberg L.P. (n.d.). Using the FOMC members' median dot plot projections. Accessed on 10/15/2023.



## Rating Agencies Concerns Highlight G-SIBs' Financial Strength

Following the regional banking debacle, Fitch's decision to downgrade the operating environment for U.S. banks from AA to AA- in June did not immediately lead to downgrades of individual banks.[5] However, this sparked concerns among investors, as rumors circulated of potential further downgrades. It's important to note that individual banks cannot be rated higher than their operating environment. Thus, another downgrade would necessitate Fitch to reevaluate ratings for over 70 banks, irrespective of their balance sheet health.

Fitch remains neutral on the operating environment, and on August 17th stated that several scenarios would need to play out for it to consider a change in stance:[6]

- Deep impact from regulatory responses on bank profitability;
- Credit losses on longer-duration holdings like CRE loans exceed normalized losses;
- Tighter credit conditions persist for an extended period; and
- Non-normal net deposit outflows from bank deposits.

In August, Moody's joined the chorus of concerns about rising rates, downgrading 10 banks and placing six others on negative watch. Two weeks later, S&P downgraded five regional U.S. banks by one notch and signaled negative outlooks for several others. All the banks downgraded by Moody's are classified as regional banks.[7]

Regional banks being the focus of downgrades underscore the resilience of globally systematically important banks. On June 30th, the 23 largest U.S. banks cleared the Fed's annual stress test, demonstrating their capacity to meet capital requirements even in a hypothetical recession. The stress test exclusively covers banks categorized as G-SIBs, which adhere to more stringent regulations compared to their counterparts.[8] Notably, the eight largest banks, known as Category I G-SIBs, promptly raised their Q3 dividends once the mandatory waiting period following the stress test results had concluded.

### CATEGORY I G-SIBS INCREASE DIVIDEND DISTRIBUTIONS AFTER SUCCESSFUL STRESS TESTS

Source: Global X ETFs with information derived from: Bloomberg L.P. (n.d.). Data as of 9/30/2023.

| Category I (G-SIBs) | Q2 2023 Dividend | Q3 2023 Announced | % Change |
|---|---|---|---|
| Bank of America Corp | 0.22 | 0.24 | 8.29% |
| Bank of New York Mellon Corp | 0.37 | 0.42 | 13.51% |
| Citigroup Inc | 0.51 | 0.53 | 3.58% |
| Goldman Sachs Group Inc | 2.5 | 2.75 | 10.00% |
| JP Morgan Chase & Co | 1 | 1.06 | 5.91% |
| Morgan Stanley | 0.78 | 0.85 | 8.97% |
| Wells Fargo & Co | 0.3 | 0.35 | 16.67% |
| State Street | 0.63 | 0.68 | 7.94% |
| **Average** | | | **9.36%** |

Beyond the rise in common equity dividends, these banks continued to grow earnings. Highlighted in Q2, JPMorgan reported a 67% year-over-year (YoY) increase in earnings, and Wells Fargo reported a 57% YoY increase. Among the broad basket of diversified banks, there were upside surprises in Q2

earnings of 8.14%, compared to 2.3% for the regional bank index counterpart.[9] This trend has continued into Q3, with nine out of ten banks reporting as of October 24th. Over 50% of US diversified banks have beaten earnings by at least 10%, and all the banks have beaten revenue, except for PNC Financial Services. In comparison, regionals have, on average, missed revenue by -0.04% so far.[10]

## Large Diversified Banks Caught in a Regional Bank Regulatory Storm

Parallel to the rating agencies, regulatory authorities embarked on a course to mitigate the risk of contagion if regional banking woes see a spark from higher rates. In late August, regulators unveiled a proposal to extend the long-term debt requirements which were initially established under the Total Loss-Absorbing Capacity (TLAC) rule for banking institutions holding assets above $250 billion following the Global Financial Crisis (GFC). On August 29, 2023, U.S. federal banking regulators issued a joint notice of proposed rulemaking that would require certain mid and large banking organizations to issue and maintain minimum amounts of long-term debt ("LTD") for banks with assets between $100 billion to $250 billion, a segment that was previously not part of the TLAC requirements.[11]

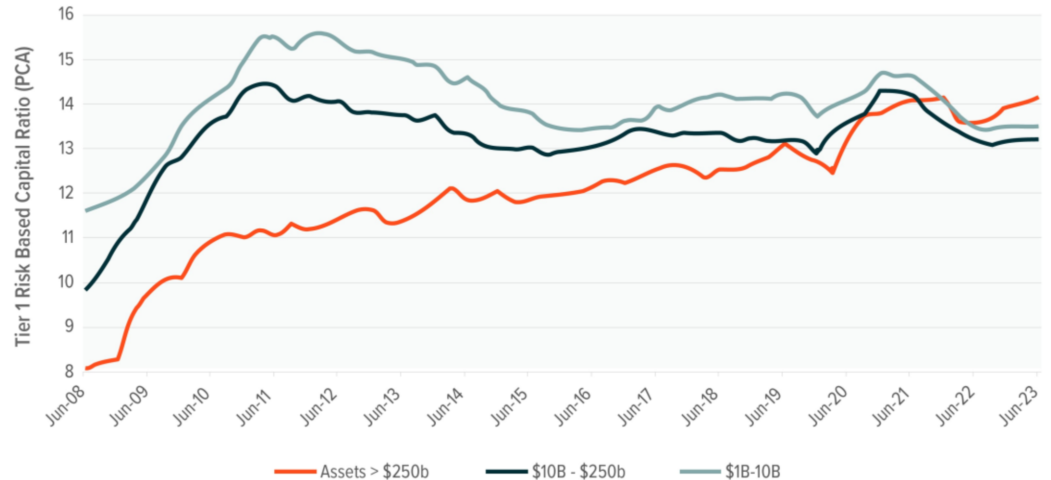
These proposed standards would have applied to institutions at the center of the regional banking crisis, including Silicon Valley Bank, Signature Bank, and First Republic.[12] In the future, such standards could ease the strain on the Federal Deposit Insurance Corporation (FDIC) and unsecured depositors, providing banks in this category a larger buffer to address deposit outflows. Only a handful of institutions currently fall into this asset range, including Regions Bank, M&T Bank, Citizens Financial, Northern Trust, and Fifth Third Corp.[13]

In contrast, the Category I G-SIBs have operated under the TLAC rule for years. The Federal Reserve Board initially embraced the final TLAC requirements in 2016 after undergoing several revisions following the Global Financial Crisis (GFC). These revisions required G-SIBs to reduce risk and ensure compliance with stringent regulations, enhancing their preparedness for economic uncertainties.

The graph below shows that G-SIBs (Global Systemically Important Banks) with total assets exceeding $250 billion have maintained higher Tier 1 capital to risk-weighted assets ratios. Higher Tier 1 capital signifies greater financial strength compared to their equity capital and total risk-weighted assets. Conversely, these ratios have declined for small and medium-sized banks. This decline underscores why regulators are proposing regulations for banks with over $100 billion in assets. As witnessed during the regional bank debacle, these banks may be more "systemically" important than previously thought, and a new round of failures could potentially spark turmoil in the U.S. economy.

### TIER I CAPITAL RATIOS REMAIN ROBUST FOR BANKS WITH OVER $250 BILLION IN TOTAL ASSETS

Source: Global X ETFs with information derived from Bloomberg, L.P. (n.d.). Data is from 06/30/2008 to 6/30/2023. Tier 1 Risk Based Capital Ratio PCA Assets Series. Asset buckets represent the total amount of assets held by the aggregate of small ($1-10b), mid ($10-250b), and large-sized U.S. banks or G-SIBs ($250b+).

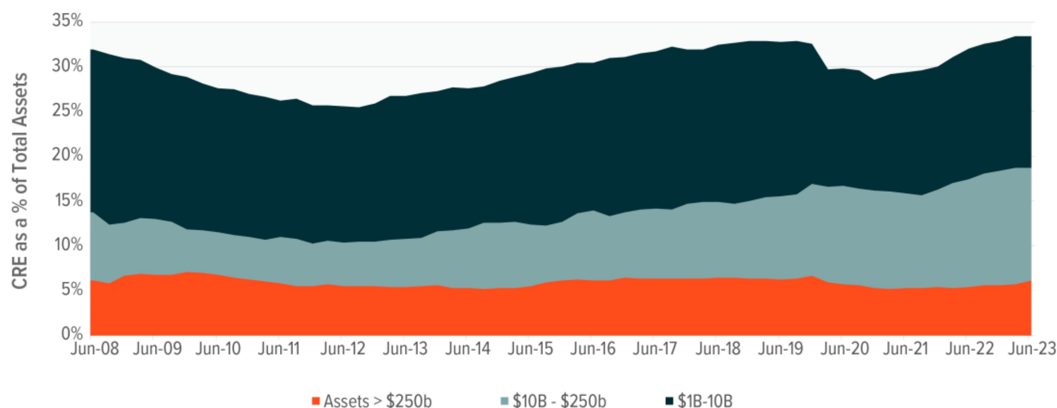



## Smaller Depository Institutions Taking a Larger Piece of the Commercial Real Estate (CRE) Pie

Over the past decade, the largest banks have worked to reduce their risk exposure, including in higher profile areas like commercial real estate. While larger banks have been stepping away, regional and smaller banks have filled the void and taken a larger share of the CRE market. According to an early 2023 JPMorgan report, regional banks had 4.4 times more CRE exposure than large banks.[14] CRE holdings among the smallest issuers comprised over 200% of common equity tier 1 capital, putting additional pressure on regional bank balance sheets.[15] Large banks, those with over $250 billion in assets, now hold CRE assets at just over 6% of their balance sheets on average, in contrast to banks with assets between $10 and $25 billion at 19%, and those with assets between $10 and $1 billion at 33%.[16] Both segments exhibit significantly higher exposure levels compared to June 2008, indicating that while the largest depository institutions have been de-risking due to tighter regulations, smaller institutions including regional banks have been stepping in to fill the void.

**MID-SIZED BANKS EMBRACE A LARGER SHARE OF COMMERCIAL REAL ESTATE AS LARGER BANKS DE-RISK**

Source: Global X ETFs with information derived from Bloomberg, L.P. (n.d.). Commercial Real Estate Loans as a % of Total Assets. Asset buckets represent the total amount of assets held with each bucket. Small, represents $100M-$1b; mid, represents $10-250b; large-sized U.S. banks or G-SIBs, represent $250b+ from 6/30/2008 to 6/30/2023.




## Part II Overview: The Rise of G-SIBs in the Preferred Space and the Role of the Global X U.S. Preferred ETF

Globally Systemically Important Banks (G-SIBs) have displayed remarkable resilience throughout this unprecedented shift from a zero-interest-rate policy (ZIRP) to the highest federal funds rate since 2001.[17] The higher interest rates may indeed impact overall bank earnings, but the solvency risk for these major institutions remains notably low.

We observe certain challenges in the banking sector with common equity and bonds, but an asset type like preferreds occupies a favorable middle ground. Bank common equities may be priced lower due to the de-risking stance adopted by banks, as well as the consideration of a later-stage economic environment. In the fixed-income sector, rising rates and duration present concerns for investors seeking lower volatility, a departure from what these investors have historically been accustomed to

Preferreds issued by the same institutions tend to offer higher yields due to their position lower in the capital stack. The solvency risk associated with the largest banks remains muted, further enhancing the appeal of preferreds, as investors can lock in higher yields for an extended period. In addition, valuations remain attractive in this pocket of the market, potentially creating a nice entry opportunity for value investors looking to invest in the banking sector.

As we delve into Part II of this series, we will explore how Global Systemically Important Banks (G-SIBs) have become significant issuers in the preferred space. We will also examine how the Global X U.S. Preferred ETF (PFFD) can serve as an investment vehicle for those seeking expanded exposure to G-SIBs while delivering an enticing valuation case when looking at metrics like yield-to-worst, compared to other asset classes.

## Conclusion: Resiliency in G-SIBs

Considering recent rating agency downgrades and potential regulatory interventions aimed at stabilizing regional banks, sentiments toward the banking sector may have experienced a temporary dampening. However, amidst these challenges, large and diversified G-SIBs have emerged as a beacon of resilience. This is evidenced by their results in the 2023 Fed Stress tests, effectively managing duration-sensitive loan exposure, such as in commercial real estate, and maintaining robust capital ratios. These factors underscore the notable divergence between G-SIBs and their smaller banking counterparts.

## Footnotes

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## Glossary

**Duration:** A measure of a bond's price sensitivity to changes in interest rates. In general, the higher the duration, the more a bond's price will drop as interest rates rise (and the greater the interest rate risk).

**G-SIBs (Global Systemically Important Banks):** are financial institutions that have a significant impact on the global financial system due to their size, complexity, and interconnectedness. They are subject to stricter regulation and supervision to mitigate the risks they pose to the overall stability of the financial system.

**Diversified Banks:** Financial institutions that offer a wide range of banking services and products to both retail and commercial customers. They have diversified operations and business lines, providing services such as savings and checking accounts, loans, mortgages, credit cards, investment banking, wealth management, and insurance products.

**Regional Banks:** Financial institutions that operate in a specific geographic region or a limited number of states. They provide banking services to local communities and businesses, offering products such as deposits, loans, and mortgages. Regional banks serve as important sources of credit and financial support for small and medium-sized enterprises (MSEs) and individuals in their respective regions.

**Uninsured deposits:** Refer to the portion of a depositor's funds held in a bank that exceeds the maximum limit covered by deposit insurance. In the United States, the Federal Deposit Insurance Corporation (FDIC) provides deposit insurance coverage for eligible deposits up to $250,000 per depositor, per insured bank.

**Federal Funds Futures:** Derivatives contracts based in which the underlying asset is the Federal Funds Rate.

**S&P 500 Regional Banks Sub Industry Index:** Measures a capitalization-weighted basket of Regional Bank equities within the S&P 500 Index.

**S&P 500 Diversified Banks Sub Industry Index:** Measures a capitalization-weighted basket of Diversified Bank equities within the S&P 500 Index.

**Net Interest Margin:** Is a financial metric that measures the difference between the interest income generated from a financial institution's interest-earning assets (such as loans and investments) and the interest expenses paid on its interest-bearing liabilities (such as deposits and borrowings).

**Discount Window:** The Federal Reserve Discount Window is a lending facility and tool used by the U.S. Federal Reserve to provide short-term loans to eligible depository institutions, such as banks and credit unions, to address liquidity needs and support the stability of the financial system during times of stress or emergency.

**Yield Curve:** The yield curve is a graphical representation of interest rates on debt for a range of maturities. It shows the relationship between the interest rate (or cost of borrowing) and the time to maturity of the debt. Typically, the yield curve illustrates the yields on government bonds, such as U.S. Treasuries, but it can also represent yields on corporate bonds or other fixed-income securities. The shape of the yield curve can provide insights into the market's expectations for future economic conditions.

**Category I Banks:** These are financial institutions that have been designated by regulatory authorities, such as the Financial Stability Board (FSB), as being of the utmost systemic importance to the global financial system. The Category I designation is reserved for the largest and most interconnected banks, which, in the event of financial distress or failure, could have severe adverse effects on the global financial stability.

**Front-End Rates:** also referred to as short-term interest rates, are interest rates that apply to financial instruments or securities with relatively short maturities, typically ranging from overnight to a few years.

**Tier 1 Capital Ratio:** The ratio is a key financial metric that measures a bank's core equity capital as a percentage of its risk-weighted assets, serving as an indicator of its financial strength and ability to withstand economic downturns.

**Yield-to-Worst:** Is a financial metric used in bond investing to estimate the lowest possible yield that an investor might receive from a bond or hybrid security, assuming the issuer exercises any applicable call option, or the bond is redeemed early. The metric provides investors with a conservative estimate of potential returns, accounting for scenarios where a bond may not each its full maturity.

**Bank Deposit Costs:** Are the expenses incurred by a bank in attracting, managing, and maintaining deposits from customers. These costs may include interest paid on savings or time deposits, promotional expenses to attract deposits, and administrative costs related to managing deposit accounts.

**S&P Regional Bank Select Industry Index:** Is a financial market index that tracks the performance of regional banks within the broader financial sector. This index provides a benchmark for investors to gauge the overall performance of regional banks in the United States. It includes companies that are primarily engaged in traditional banking activities, such as providing various financial services and products to consumers and businesses within specific regions or markets. The S&P Regional Bank Select Industry Index is a sub-index of the S&P Select Industry Indices, which group companies within the same industry for comparative and analytical purposes.

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