PPMAMERICA

Post Hoc: US Regional Banks After the Crisis

FIXED INCOME INSIGHTS – OCTOBER 2023

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KEY TAKEAWAYS

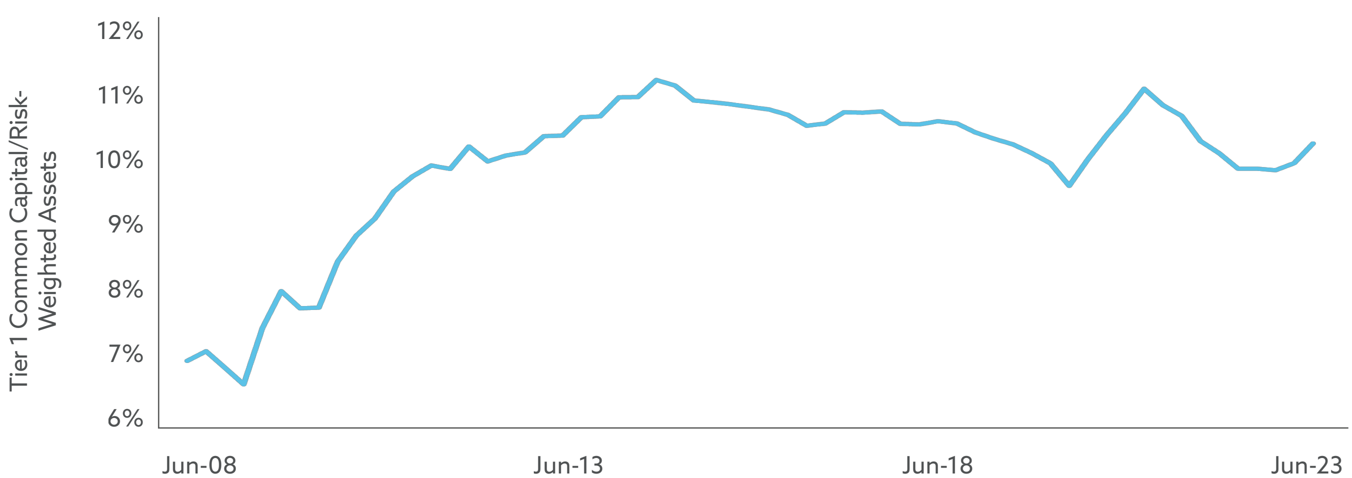
> Regulatory proposals have raised the prospects of significant new bond issues for US regional banks, with potential repercussions for investor portfolios and analysis needed to find the best-positioned banks

> PPM America (PPM) consistently researches and invests in the sector on behalf of our clients; there are long-term risks but also opportunity, as we expect increased capital levels to be credit positive

The spring's US regional banking crisis thrust the sector to the forefront for investors.[1] While it may have moved to the background since, interest rates are high and the potential remains for deposit flows. Further, regulators have proposed new balance sheet minimums that would require much higher capital buffers. All of this imposes more active monitoring and research requirements on investors. PPM's credit research team just returned from a global financial conference, and we wanted to update clients on the latest regional bank developments.

At the end of August, the FDIC addressed higher capital buffers with its proposed long-term debt requirements.[2] The proposal requires long-term debt equal to the greater of 6% of risk-weighted assets, 2.5% of leverage and 3.5% of average consolidated assets and is applicable to so-called Category II-IV banks. Such banks have at least $100B in assets, a threshold that would have included Silicon Valley Bank, Signature Bank and First Republic Bank before their failures. Finally, there is a three-year phase-in period. The proposal is manageable for regional banks, in our view, given the phase-in period and requirements that are lighter than feared (e.g., requirement just for long-term debt instead of total loss absorbing capital; leverage minimum lower-than-expected). Questions do remain, in particular the extent to which certain existing bonds are included in the calculations.

REGULATIONS LIKELY TO DRIVE REGIONAL BANK CAPITAL TO NEW HIGHS[3]



(1) As of 2 October 2023. Unless otherwise stated, the information presented has been prepared from market observations, PPM's notes, observations and interactions during the Barclays Global Financial Services Conference, and other sources believed in good faith to be reliable. Information, summaries, notes and opinions expressed by PPM are current as of the date indicated and do not make any representations on behalf of presenters at the Barclays Global Financial Services Conference. Past performance is no guarantee of future results. Forward-looking statements are subject to uncertainties that could cause actual developments and results to differ materially from the expectations expressed. (2) FDIC. "Fact Sheet on Proposed Rule to Require Large Banks to Maintain Long-Term Debt to Improve Financial Stability and Resolution." 29 August 2023. (3) Federal Reserve, SNL Financial, Bloomberg, company reports. As of 30 June 2023. Core common capital (equity) as defined by regulatory guidelines, or Tier 1 Capital less preferred stock, TruPS and minority interest, for the 11 regional banks PPM tracks.

Nevertheless, we expect significantly more issuance, not only due to the FDIC's long-term debt proposal but the Basel III endgame proposal the Federal Reserve (Fed) announced in the summer.[4] For the former, JP Morgan has estimated that 15 Category II-IV banks currently have long-term debt shortfalls using the new FDIC requirements, estimating a total shortfall of $72B.[5] The Basel III endgame proposal itself could raise regional bank risk-weighted assets by low double digits (likely low-to-mid teens), requiring even more capital on balance sheets. We think companies should begin providing updated outlooks for issuance in October during their third quarter earnings reports.

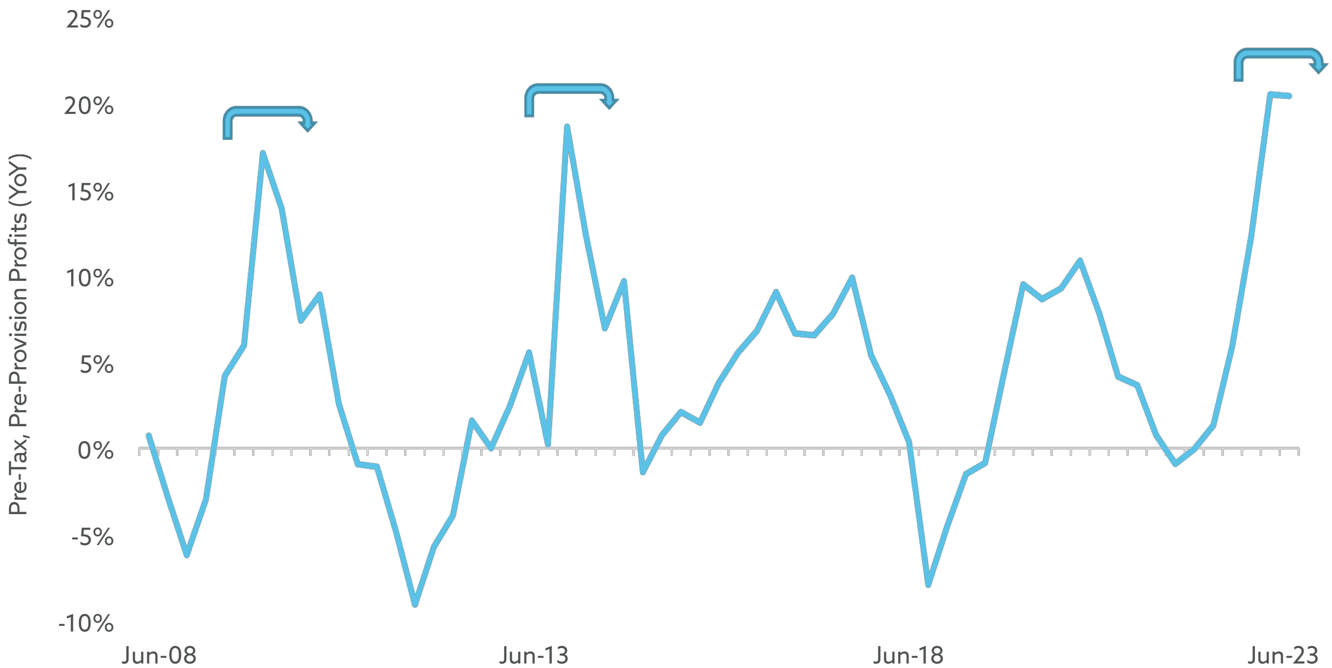
Our fundamental view of US regional banks remains cautious, as structurally higher debt balances and funding costs should provide a significant profitability headwind in coming quarters.

We also believe that the impact of higher capital buffers will have repercussions for lending. Our discussions revealed some regional banks are targeting lower risk-weighted assets in an effort to reduce the amount of capital they have to raise. An unintended consequence could be reduced lending appetite and capacity, which could have negative impacts on the broader economy. One bank already provided numbers, aiming to reduce its non-core portfolio by $9B by the end of 2025. Such moves could worsen the already tight lending standards environment brought on by the Fed's rate hiking cycle.[6]

Lastly, the sector may see more consolidation given that scale could offset higher costs for regulatory compliance and lower profitability. Themes could be acquisitions of smaller banks (<$100B) and the potential for banks already above $100B to grow and move up categories (e.g., move up from Category IV to Category III).

In summary, the landscape for US regional banks over the long-term includes potentially significant risks. While we are cautious on the sector, we also see potential opportunities. Although banks may experience lower profitability in the coming quarters, increased capital levels (and likely lower shareholder returns) are positive for creditors. PPM relies on bottom-up fundamental analysis to make investment decisions, which could prove to be important as developments in the banking sector evolve. We welcome the opportunity to offer clients help in navigating this changing landscape.

WE BELIEVE REGIONAL BANK PROFITABILITY WILL ROLL OVER[7]



(4) Federal Reserve. 27 July 2023. (5) JP Morgan. 29 August 2023. Analysis used financial metrics as of Q2 2023 and eligible total loss absorbing capacity and/or long-term debt outstanding as of August 2023. (6) Federal Reserve. Senior Loan Officer Opinion Survey on Bank Lending Practices. July 2023. (7) Federal Reserve, SNL Financial, Bloomberg, company reports. As of 30 June 2023, the latest available. Rolling four-quarter PTPP profits for 11 US regional banks tracked by PPM, shown as year-over-year growth rates. PTPP profits = net interest income + non-interest income - non-interest expenses + goodwill impairment/intangible amortization charges + mortgage reps and warranty charges.

ABOUT PPM AMERICA

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Our mission is to deliver specific client solutions and service to investors around the world with the goal of meeting investors' unique investment objectives. In addition, PPM employees are committed to building our community and supporting local nonprofits that strengthen families and increase economic opportunities.

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