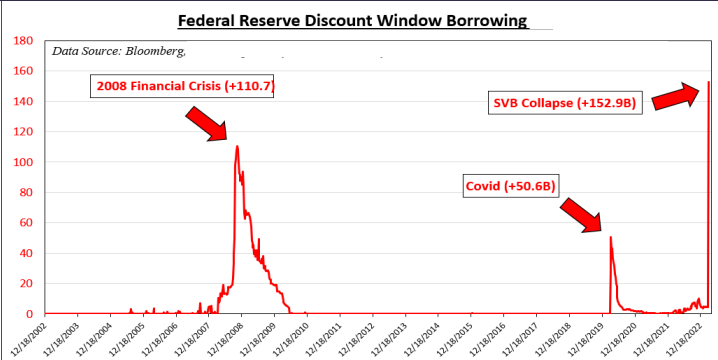


Liquidity Pressures and Interest Rate Volatility Cloud Near-Term Outlook for Banking Sector Financial Performance

The last two weeks represented a period of unprecedented interest rate volatility and global banking instability. The problems facing the industry are not asset quality related nor are they capital adequacy related. Rather, the rapid rise in interest rates over the past year has significantly reduced the value of banks' bond portfolios, leaving them vulnerable to mark-to-market losses should they need to quickly raise liquidity. Then, the failures of Silicon Valley Bank and Signature Bank triggered a broader market panic, flight to safety, and reallocation of deposits. With the Fed's Federal Open Market Committee meeting this week, they face a difficult tradeoff between financial stability and inflation control as they evaluate the path of interest rates while attempting to ward off broader liquidity risk contagion and a credit crunch.

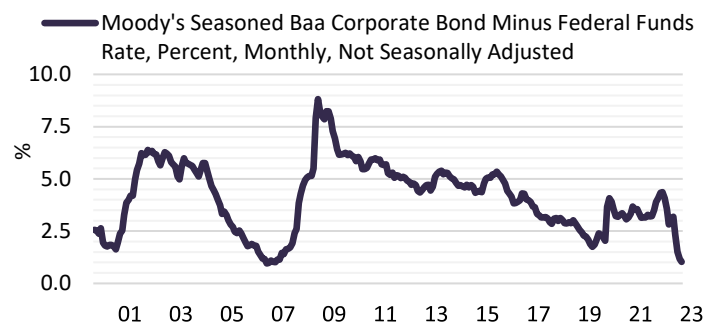
Fed Discount Window Borrowing



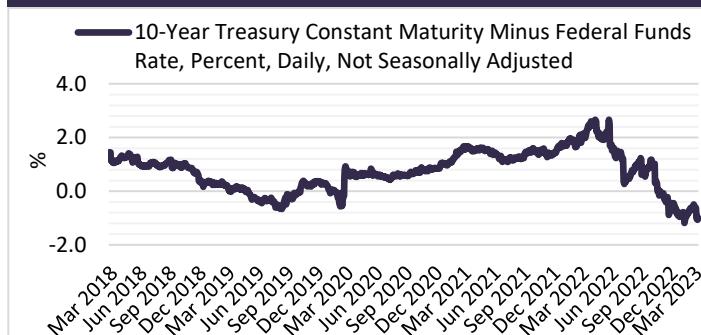
The Fed's main direct lending facility, the Discount Window, also saw record draws (chart above). Last week alone saw record draws of \$153 billion, with average daily activity exceeding \$80 billion. During a typical week, borrowing at the Discount Window usually represents only \$4 to \$5 billion. While wild swings in bank stocks and Treasury yields and concerns about the future path of interest rates have markets on edge, credit spreads (right chart) remain subdued. When investors worry about risks increasing, the spread rises, and usually jumps when a recession is imminent.

Regulators delivered a powerful response by guaranteeing all deposits of the failed banks and rolling out a new facility that allows all banks facing out-sized withdrawals to pledge Treasury and other high-quality securities for one-year funding at par value, rather than selling off those securities and realizing a mark-to-market loss. The scale of the stress on the banking system is evidenced by recent changes to the Fed's balance sheet. Draws on the aforementioned term funding facility have already exceeded \$12 billion, and bridge loans to the failed banks totaled \$143 billion.

Credit Spread Trend



Treasury Spread Trend



Conversely, another reliable predictor of recessions – an inverted yield curve – has been inverted significantly for some time now. Last week marked the year anniversary of the Federal Reserve's current tightening cycle, raising rates eight times. The effect of rate increases on the economy work with a lag, however, often taking 12 to 18 months to make their way into the economy, which is why so many prognosticators have been calling for a recession in the second half of 2023.

Why RMA and AFS?

RMA and AFS are committed to providing relevant, timely, and practical credit risk solutions to banks. Combining the strengths of each to offer information and insight, RMA and AFS are ideally situated for collaborations aimed at identifying and responding to the credit risk needs of financial institutions.

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