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Market and Economic **Update**

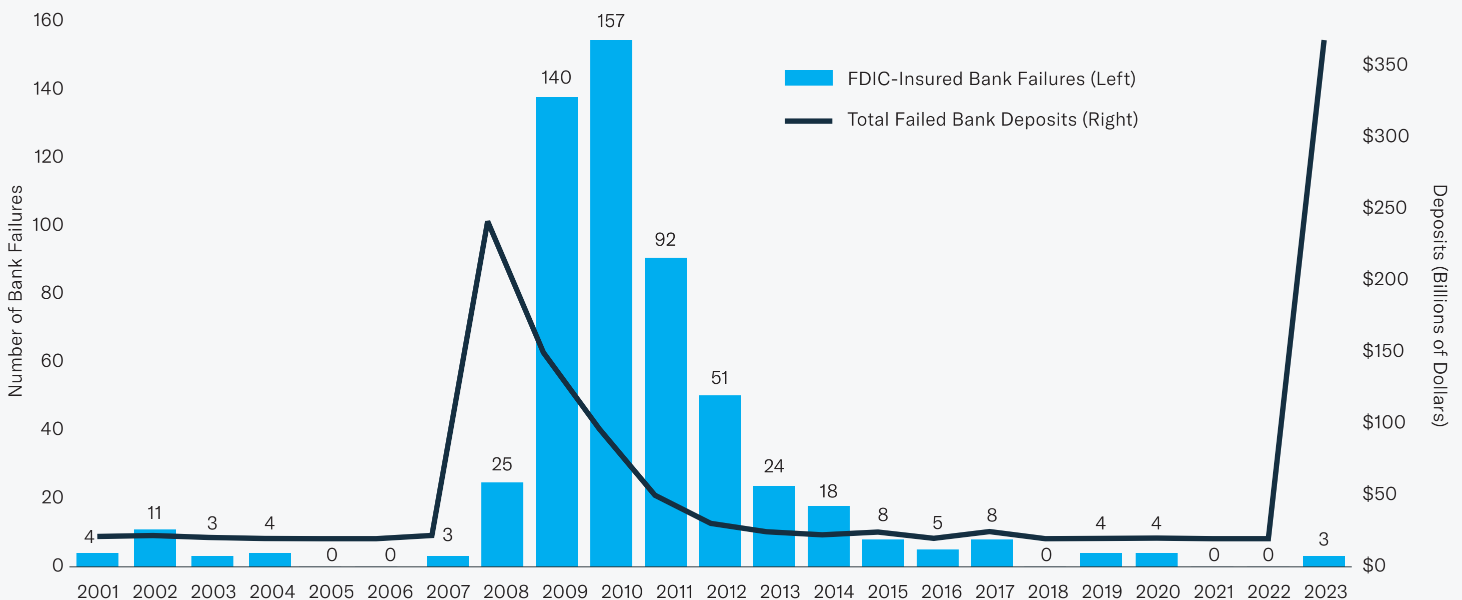
How the Failure of First Republic Impacts the Financial System

MAY 2023

On the morning of May 1, it was announced that First Republic Bank had been taken over by the FDIC and sold to JPMorgan Chase. Eleven major banks had previously infused First Republic with $30 billion in deposits to stabilize the bank after the failures of Silicon Valley Bank, Signature Bank, and Credit Suisse. This process found new urgency over the prior week, when First Republic revealed that uninsured deposits at the bank fell $100 billion in the first quarter. Thus, this deal had been in the making for several days, with multiple large banks bidding on First Republic's deposits and assets. With ongoing banking turmoil creating market and economic uncertainty, how can long-term investors navigate the months ahead?

The orderly sale of First Republic is positive, but its failure mirrors the other bank failures that occurred almost two months prior. These banks grew aggressively by pursuing deposits that proved to be unstable when the economy slowed, and parts of the tech sector faltered. While this alone would create stress for any bank, rising interest rates also resulted in unrealized losses in their bond portfolios, which normally do not need to be marked-to-market if they are expected to be held until maturity. However, falling deposits forced these banks to sell bonds and realize these losses.

1. Three FDIC-insured banks have now failed with a total of $368 billion in deposits

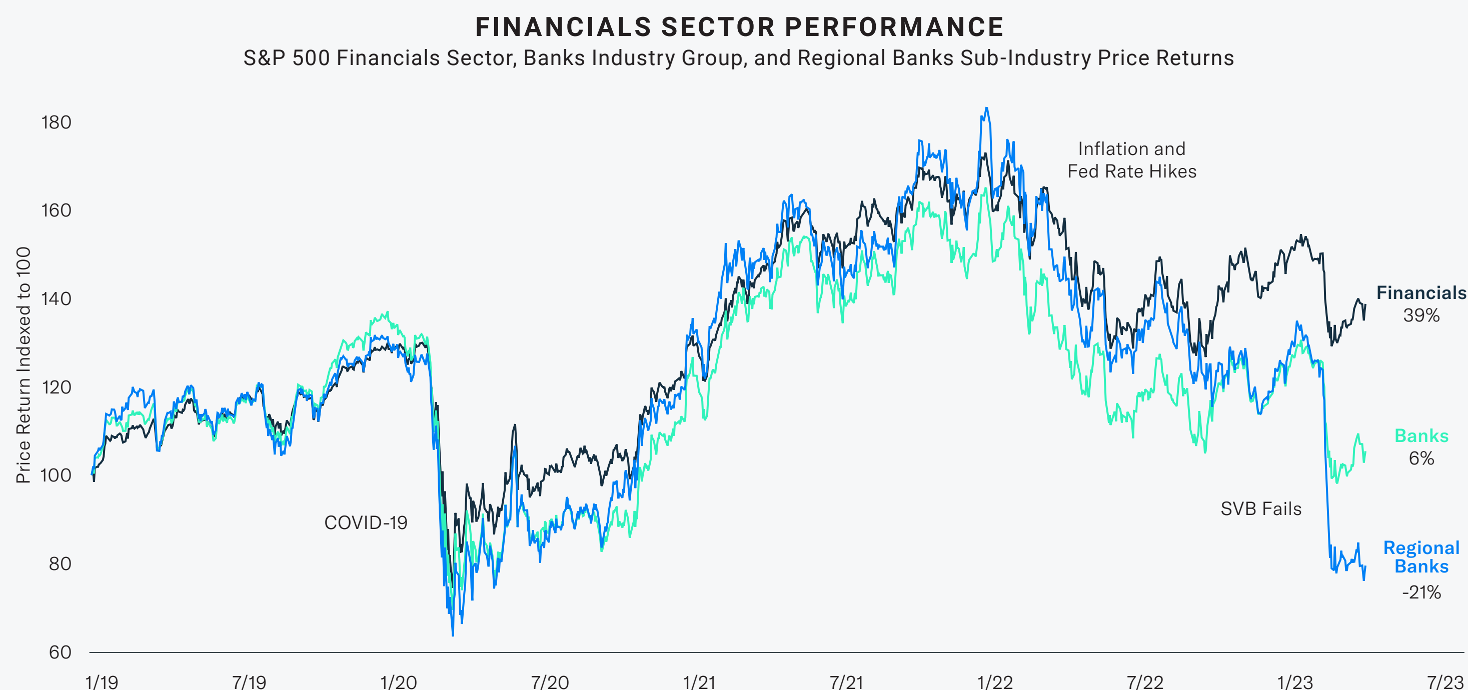


Sources: Clearnomics, FDIC, January 2001 to April 2023.

Thus, this banking crisis is the result of both a failure of risk management specific to these banks, and the broader tightening of financial conditions due in large part to Federal Reserve (Fed) rate hikes. However, banking crises are not new, and many of the biggest market shocks since the late 19th century have been due to tremors in the financial system. The Panic of 1873, for example, occurred when one of the largest banks, Jay Cooke & Company, failed due to bad bets on railroads. Others include the Panic of 1907, the 1929 crash, the Savings and Loan crises throughout the 1980s and 1990s, the 2008 global financial crisis, and many other international crises.

What all these historical episodes have in common is the availability of money, the expansion of credit, and the eventual tightening of financial conditions. Like a sugar rush, a rapid increase in money and credit through the global financial system can drive asset bubbles and risk-taking in a particular market or across a whole country. Sooner or later, however, there is a sugar crash as returns peter out, sentiment shifts, and conditions tighten.

2. The banking crisis has been concentrated in specific regional banks



Sources: Clearnomics, Standard & Poor's, January 1, 2019 to April 30, 2023. Past performance is no guarantee of future results.

> During times of market uncertainty, the best approach is to stay diversified and not overreact to news headlines.

Thus, the question today is whether there will be broader economic instability or if the situation is contained. There are many surface-level parallels to 2008, which are raising investor concerns, including JPMorgan Chase's acquisition of Bear Stearns in March 2008. As the nation's largest bank, it is not surprising that it would play a role in any financial crisis. The Fed had also raised rates prior to 2008 and the economy had appeared to be in decent shape based on growth figures.

However, while the phrase "this time is different" can be dangerous, there are many distinctions between now and the situation fifteen years ago. The most important is the amount of leverage in the system. The global financial crisis of 2008 was not just about the housing bubble - the main issue was that banks and other institutions held significant leverage in the form of derivatives which magnified the impact of the housing market collapse. This means that even small upticks in default rates and bad loans were enough to cause large financial institutions to fail. If falling bond prices are seen as a parallel to falling home prices, there would need to be layers upon layers of leverage on these bonds to truly mirror 2008. This does not seem to be the case.

The bottom line? Long-term investors should continue to maintain perspective considering the ongoing banking crisis. A combination of company-specific factors, as well as the broad macroeconomic environment, led to challenging conditions for these particular banks. However, parallels to 2008 and other historical episodes are premature. During times of market uncertainty, the best approach is to stay diversified and not overreact to news headlines.

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