Bank Runs in the Digital Age

What Happened

The recent turmoil in the banking industry is unlike anything experienced since the Great Recession in 2008. The successive failures of Silvergate, Silicon Valley Bank, and Signature Bank, followed later by First Republic, has caused a sharp sell-off in bank stocks that for the most part seem completely disconnected from fundamentals. While rising interest rates, bank securities portfolios, and capital levels played a role in the recent failures, the primary culprit was the high concentration of uninsured deposits. The risk of these concentrations was compounded by the speed at which deposits can now flow between institutions.

When Washington Mutual failed in 2008, $16 billion flowed out of the bank in nine days. In contrast, Silicon Valley lost $42 billion the first day and had $100 billion scheduled for the following day before the FDIC stepped in and seized the bank. The contagion quickly spread to several healthy banks following the initial announcement by regulators that uninsured deposit holders at Silicon Valley would receive a certificate of receivership, implying a potential haircut on their deposits. This created a feedback loop at First Republic: some deposits fled, causing the stock price to drop, which led to more deposits leaving. This has created an unusual environment where stock prices can drive fundamentals, rather than the other way around. It also creates the opportunity for hedge funds to influence the fundamentals of banks by aggressively shorting or purchasing puts on bank stocks.

How We Responded

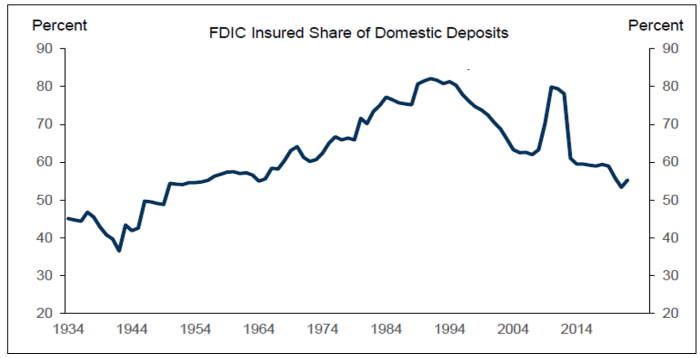
While events were rapidly unfolding, we immediately stress-tested our bank holdings across a variety of measures. These included uninsured deposit concentration, industry concentration of customers, unrealized losses from securities portfolios, stressed capital levels, and liquidity. We also sought to understand the risks of contagion and how stress amongst the regional banks can impact the community banks where we invest.

In addition to proactively setting up calls to talk about the situation with our clients, we reached out to the management teams of numerous banks in our portfolio to find out if they had any concerns about depositor outflows and rising funding costs. In the ensuing weeks, it became increasingly clear that with a few exceptions in the regional bank space, banks were not seeing a rapid exodus of deposits. While deposits have generally been shifting to higher yielding accounts, thereby increasing funding costs for banks in our portfolios, they continue to maintain sufficient liquidity.

What Needs to Happen

The banking industry has been characterized by steady evolution over time. However, the pace of change in the past ten years has been especially fast. Technology has increased the speed at which deposits can move from bank to bank. Previous bank runs happened slowly as customers would often visit the branch to fill out cumbersome paperwork, receive a paper check, or arrange for a wire. Now, customers can transfer funds to an account outside of their bank in seconds. For customers with deposits over the insured limit of $250,000, any concern that the bank may be in trouble or deposits may already be leaving could result in a stampede for the exits.

Given this new reality, the FDIC could ease depositor concerns and significantly reduce the risk of potential bank runs by dramatically increasing the insured limit on deposits. Because the deposit insurance fund is paid for by the industry itself, this could be done at no cost to taxpayers. However, such a move would require Congress to pass legislation to raise the limit, and that body seems less inclined to act until the situation becomes more dire.

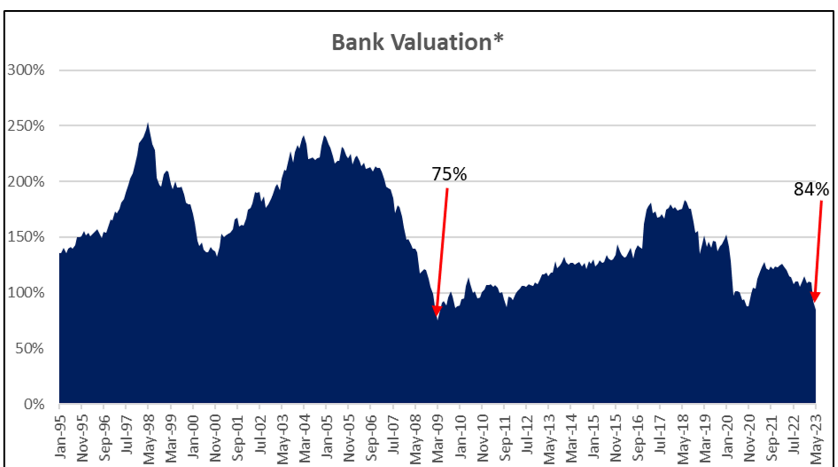


What We Have Learned

Given the recent volatility in the banking sector, we have increased the frequency and depth of our contact with bank management teams, analysts, and other investors. Additionally, two members of our investment team recently attended a bank investor conference headlined by bank CEOs & CFOs. They returned to Pacific Ridge with an increased understanding of how banks have been impacted by recent events and what these executives are seeing in their markets.

For the most part, it does not appear that current stock prices reflect current fundamentals. Credit deterioration is typically a drawn-out process that plays out over multiple years. While the general consensus is that a credit cycle is inevitable, the banks with whom we have spoken have yet to see the initial signs of trouble. To date, the well-publicized distressed office properties largely remain outside of the banking industry and are likely held by insurance companies, pension funds, and CMBS pools.

We believe that the economy will likely weaken and potentially tip into a recession. We also believe there is a possibility of additional bank failures. That said, current valuations have not been at this level since the depths of the 2008 Financial Crisis. This dichotomy seems difficult to reconcile given higher capital levels, tighter underwriting, and the long anticipated economic downturn.



*Represented by the Median Bank Price/Tangible Common Equity Ratio for the small bank universe

The disconnect between traditional stock fundamentals and current stock volatility in the banking industry has generated headlines and created uncertainty in this sector. At Pacific Ridge, we continue to invest with a long-term horizon, while taking advantage of short-term disruptions in the market. Combining our contrarian value approach to investing with increased contact with banking executives and macro environment research, we continue to seek out quality companies that conform to our investment philosophy.

Sincerely,

Pacific Ridge Capital Partners