Flaherty & Crumrine: Bank Update

March 21, 2023

Over the past two weeks, the preferred and contingent capital securities market has been roiled by the liquidation of Silvergate Capital Corp, and the receiverships of Silicon Valley Bank and Signature Bank NY. On March 19, Credit Suisse Group was taken over by UBS Group ("UBS") at the behest of Swiss bank regulators and included a full write down of Credit Suisse Group's contingent capital ("CoCo", or Additional Tier-1) securities. These events were triggered by deposit withdrawals straining the banks' liquidity, despite strong regulatory capital positions at each of these banks.

While it is still very early in these resolutions, in the case of the U.S. banks, the normal priority of losses will apply, with common equity absorbing losses first, followed by preferred securities, subordinated debt, and more senior claims thereafter. The Credit Suisse situation was different: common shares received CHF 3 billion of UBS common stock, while its CoCos received nothing. Although the terms of the securities appear to give Swiss regulators that authority in limited circumstances, it was a shock to the broader CoCo market that Swiss regulators took this approach which led to sizable declines in market prices on Monday, March 20, 2023. In response to this unique Swiss position, the European Central Bank, the Bank of England and OSFI of Canada made clear statements that CoCos/Limited Recourse Captial Notes("LRCN") in their jurisdictions rank ahead of common equity and behind tier-2 capital (a form of subordinated debt), prompting a partial recovery of earlier declines. U.S. companies do not issue CoCos/LRCNs. Among jurisdictions in which Brompton Flaherty & Crumrine Investment Grade Preferred ETF (the "Fund") has purchased CoCos, Switzerland's approach to "bail-in" is unique.

Central banks have extended significant liquidity to banks to accommodate deposit outflows or other liquidity needs. In addition to the discount window, which accepts a broad range of collateral, the Federal Reserve (the "Fed") established a new Bank Term Funding Program that allows borrowers to pledge certain collateral at par value without "haircuts" to market value that apply at the discount window. Borrowing from these facilities expands the Fed's balance sheet and enhances overall bank liquidity. In addition, the Federal Home Loan Bank system continues to provide funding against mortgage collateral.

Investors have expressed concern over regional bank deposits. We note that regional banks have consolidated, diversified, and grown their deposit and loan bases significantly since the 2008-09 financial crisis. They are often the go-to banks in their regions.

As of year-end 2022, U.S. banks' regulatory capital levels remained strong and loan quality was high. Non-performing loans and charge-offs were historically low, and the ratio of loan-loss provisions to non-performing loans was at a record high.

It is difficult to predict when greater stability will return to bank's deposit positions and to the preferred market, and we cannot rule out additional bank failures. Banks likely will need to raise the interest rates they pay over coming months to retain deposits. That would reduce net interest margin (NIM) earned by banks, which expanded significantly in 2022 as interest rates on loans outpaced that on deposits with the Fed rapidly raising short-term rates. We expect higher deposit rates to be an earnings headwind in 2023—but not a threat to financial stability.

The following table shows the Fund's U.S. regional and community and non-U.S. AT1 CoCo bank exposures as of February 28, 2023, including issuer-level exposures on the four banks discussed here. The Fund owned Credit Suisse, SVB Financial Group, and Signature Bank through acquisition or receivership, as applicable.

As of February 28, 2023	% of Portfolio
Silvergate Capital Corp.	0.0%
Silicon Valley Bank	0.8%
Signature Bank NY	0.4%
Credit Suisse	1.7%
U.S. Regional Banks	5.2%
U.S. Community Banks	1.3%

Remaining Non-US AT1 (CoCos/LRCNs) Breakdown as of February 28, 2023	% of Portfolio
EU AT1*	11.8%
UK AT1*	8.9%
Canada AT1*	4.9%
Swiss AT1**	1.5%
Mexico AT1	0.7%
Australia AT1	0.3%

** EU, UK, and Canadian regulators have publicly confirmed that, in their respective jurisdictions, AT1 capital will receive priority treatment over common shares in a distress scenario.*

*** Remaining Swiss exposure limited to UBS.*

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