

Bank Failures Contribute To Increased Restructuring Activity

By **Michael Eisenband** (April 18, 2023)

The sudden and spectacular failure of Signature Bank, Silvergate Bank and Silicon Valley Bank in early March pushed all other business stories off the front pages and had financial markets anxiously asking where the fallout would stop.

As unique as the underlying causes of each failure were, at their core, these were all good old-fashioned bank runs triggered by liquidity issues.

The blame game has already begun, be it overexposure to crypto businesses, overreliance on venture capital-funded startups, asset-liability duration mismatch, inadequate internal risk monitoring, lax regulation — or any combination of these factors.



Michael Eisenband

These abrupt bank failures will be fodder for hand-wringing, finger-pointing and feature-length stories for months or years to come even if the story ends here — a far-from-certain outcome. This saga might even have big-screen appeal, as do most storylines where greed, hubris and failure collide.

The emergency response plan crafted by the U.S. Department of the Treasury, the Federal Deposit Insurance Corporation and the Federal Reserve protected all depositors of two failed banks and probably prevented what would have been a domino-effect fallout on the wider economy had uninsured depositors experienced losses or the inability to access their money.[1]

More broadly, the Fed has provided a one-year lending window, the Bank Term Funding Program, for other banks to access needed liquidity on a secured basis without being forced to realize losses on high-quality securities portfolios.

However, equity investors and debt holders of those banks remain fully exposed to financial losses without any Fed protections, and this has investors and unsecured creditors on edge at similarly exposed banking institutions.

Large uninsured depositors at nonsystemically important banks are concerned as well.

Moody's subsequently downgraded its outlook for the entire U.S. banking sector to negative from stable[2] in the wake of these bank failures, despite remedial actions taken by regulators to provide access to liquidity and bolster depositor confidence. Volatility will remain high in the financial sector for the time being.

These events have complicated the task of monetary policy for the Fed, as the continuation of policy actions in place might be perceived as an unnecessary groin kick at a vulnerable moment for the banking system, while a premature pause or easing of monetary policy would seem like a panicked reaction or a capitulation to bad actors ensnared by their own moral-hazard behaviors.

It is truly a conundrum for the U.S. central bank.

Fed tightening since mid-2022 has undoubtedly drained reserves from the banking system

while higher interest rates created unrealized market losses on fixed-rate debt securities — but that is a far cry from blaming the Fed's tight money policy for causing this fallout, which some have asserted.[3]

If anything, massive monetary easing during the pandemic laid the groundwork for some poor corporate decision making whose consequences have arrived.

It's still conceivable that the Fed's stalwart fight against inflation could deviate from its intentions in early March while policymakers ponder whether the toothpaste can ever go back in the tube without exploding.

Some market pundits have speculated that recent events will hasten the end of monetary tightening cycle even as high inflation continues to linger, though several Federal Open Market Committee officials have reiterated the Fed's intention to stay the course.

Prior to these bank failures, the likely path of monetary policy was clarified by Fed Chairman Jerome Powell on March 7, when he addressed the U.S. Senate Banking Committee and commented that, "If the totality of the data were to indicate that faster tightening is warranted, we would be prepared to increase the pace of rate hikes." [4]

In Fed-speak, Powell's comments left the door open to more rate hikes or larger ones and a higher terminal value for its targeted rate, if inflation did not weaken sufficiently.[5]

Aside from rate hikes, quantitative tightening asset sales continued to run as planned, with some \$600 billion in securities coming off the Fed's balance sheet from mid-2022 through early March — before soaring again by late March after its Bank Term Funding Program opened.

Indeed, economic data to date in 2023 show that despite the Fed's aggressive efforts, the economy remains strong and resilient — as evidenced by robust employment figures and consumer spending year-over-year in the first quarter — while inflation remains unacceptably high and sticky despite an easing of key commodity prices and a moderation of global supply chain woes.

Consumer-level inflation remains in the vicinity of 5% to 6% year-over-year,[6] far above the Fed's 2% target.

Powell's March 7 comments were consistent with his previous remarks that monetary tightening would continue if economic data remained too hot despite the risks to the broader economy and increased likelihood of a hard landing.

Time will tell if these policy intentions change due to the mini banking crisis, which has "quantitative easing forever" fans believing that the Fed will once again have to turn on the money spigot to mitigate systemic vulnerabilities within the banking system.

Financial markets sold off sharply and broadly the day Powell made his hawkish comments and continued to grind lower through mid-March, erasing most gains since early January, before unexpectedly rallying this month once the banking sector stabilized.

Credit markets have lost some of their New Year mojo and offer perhaps a more sobering view of the realities of the moment, with the three-month London Interbank Offered Rate — the erstwhile benchmark rate for most leveraged loans — breaching the 5% level for the first time since 2007.

The negative spread between two-year and 10-year Treasuries reached its widest level since 1981 in early March — a highly reliable predictor of recession — before contracting of late but remaining decidedly negative.

The recent rally in leveraged credit markets has taken spreads below their worst levels of late 2022, but the all-in cost of new issuance and outstanding floating-rate debt for many B- or CCC-rated speculative-grade borrowers is still close to 10%.

Naturally, this is especially bad news for highly leveraged companies.

Recent turbulence in the regional banking sector likely will usher in a period of heightened internal and regulatory scrutiny of current business practices and exposures, capital adequacy requirements and testing for smaller banks, and more lending prudence by banks until deposit flows settle down and there is a better understanding of the ramifications of these recent failures.

Such conditions would disproportionately affect regional bank lending and their business relationships with small businesses, tech-heavy startups, middle market companies, and smaller private equity sponsors, all of whom may face more restrictive or costly access to capital.

This can only suppress business activity in these affected areas, though private capital may pick up some of the slack.

Restructuring Activity is Strong Out of the Gate

Prior to all this excitement, restructuring activity began the year with a head of steam. Chapter 11 filings have increased sharply in recent months, as anyone attached to the restructuring profession is aware.

To be more precise, average monthly filings accelerated to 15 in the last three months compared to just eight per month from mid-2021 through 2022 and a long-term average of 10.5 filings per month since 2010.

Consistent with recent years, filings to date continue to skew toward small to midsize filers, those with liabilities between \$50 million and \$150 million at filing, or what would be considered middle-market companies, while billion-dollar filings remain in relatively short supply but have picked up since early March.

Similarly, S&P rated-debt defaults soared to 37 in the first quarter, compared to 15 in the same period a year ago, with nearly 70% of these defaults being U.S.-based companies and 46% being distressed debt exchanges and out-of-court deals.

This default total tied 2016 as the strongest start to a year for defaults since 2009, according to S&P.[7]

Beyond this, the number of negative story headlines in various restructuring publications seems to grow longer each week while monthly listings of distressed debt take longer to pore over. It feels as if the pipeline of future restructuring activity is building by the week.

Less than a third of the way through the year, the strong hunch of many professionals at the end of last year that 2023 would be a busy year for the restructuring profession seems

like a safe bet, if not a sure thing.

But let's not get ahead of ourselves. Three months of elevated activity does not a trend make, though it's certainly a promising start and there's little reason to believe that it will let up, given the forces at work.

Filing activity would have to maintain this recent pace, more or less, for the remainder of the year for 2023 to be considered an exceptionally strong year. That is certainly not out of reach and, if anything, seems more achievable today than it did a few months ago; but it's still a stretch.

What is much more certain is that restructuring activity in 2023 will far exceed last year's levels, with at least 150 filings seeming highly likely versus 103 filings in 2022. That would be the best year for filings since 2016 — aside from 2020.

However, default cycle-type activity levels of 200 or more filings or rated debt defaults seem most unlikely without a shock event. Nobody is complaining.

Sponsor-owned companies are particularly exposed to the crosscurrents of a rising rate environment and a weakening economic backdrop, and this exposure is reflected in filing activity to date.

Following a two-year reprieve in filing activity, sponsor-owned companies have accounted for nearly one-third of filers in 2023, consistent with pre-pandemic filing rates and well above their filing rates in 2021 and 2022.

Again, there's little reason to believe that this will let up as the year progresses, as many sponsor-owned companies confront a most challenging year coming on the heels of two record-setting years for deal-purchase-price multiples and leverage employed.

For many private equity sponsors, it will be a year of damage control and loss mitigation, with far less new deal activity, as the banking sector's appetite for aggressive deal financing and large dividend recaps will surely diminish going forward. Maybe that's a good thing.

Michael Eisenband is the global co-leader of corporate finance and restructuring at FTI Consulting Inc.

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[1] Andrea Shalal, Howard Schneider, Pete Schroeder, "After SVB failure, US acts to shore up banking system confidence". Reuters (March 13, 2023). <https://www.reuters.com/business/finance/regulators-urged-find-silicon-valley-bank-buyer-industry-frets-about-fallout-2023-03-12/>.

[2] Jeff Cox, "Moody's cuts outlook on U.S. banking system to negative, citing 'rapidly deteriorating operating environment,'" CNBC (March 14, 2023).

[3] Gertrude Chavez-Dreyfuss, "Analysis: Declining U.S. bank reserves add wrinkle to

contentious debt ceiling issue." Reuters (March 13, 2023), Tristan Bove, "Cathie Wood blames her funds' poor performance of the Fed's aggressive rate hikes", Fortune, March 22, 2023.

[4] Jeff Cox, "Fed Chair Powell says interest rates are 'likely to be higher' than previously anticipated," CNBC via MSN.com (March 7, 2023).

[5] Davide Barbuscia, "BlackRock sees 'reasonable chance' of Fed raising rates to 6%". Reuters March 7, 2023.

[6] Paul Davidson, "Consumer price inflation rate slows to 6% in February, but prices post strong monthly gain," USA Today (March 14, 2023).

[7] "Distressed Exchanges Spur a Sharp Rise in Corporate Defaults," S&P Global Ratings (April 13, 2023).