Bankruptcies Will Continue to Pile Up No Matter Where Fed Policy Goes from Here

The sudden and spectacular failure of three regional banks within a week has pushed all other business stories off the front pages and has financial markets anxiously asking where the fallout stops. 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 VC-funded start-ups, lax or incompetent regulation or, in the case of Silicon Valley Bank, an inordinate percentage of assets held in long-term fixed-rate securities impaired by rising interest rates. 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 intersect.

The emergency response plan crafted by the U.S. Treasury Department, the FDIC and Federal Reserve will protect all depositors and has 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 lending window 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 debtholders of those banks will remain fully exposed to financial losses without any Fed protections, and this has investors and unsecured creditors on edge at similarly exposed banking institutions. Moody's just 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 Federal Reserve, as the continuation of policies in place might be perceived as an unnecessary groin kick at an already vulnerable moment for the banking system, while a 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's 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 have caused unrealized market losses on fixed-rate debt securities—but that is a far cry from blaming recent Fed policy for contributing to this fallout, which some have insinuated.[3] If anything, massive monetary easing during the pandemic laid the groundwork for some poor corporate decision-making whose consequences have arrived. For now, the Fed's stalwart fight against inflation might take an unexpected pause of unknown duration while policy makers are left to wonder if 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 even as high inflation continues to linger.

Prior to these bank failures, the likely path of monetary policy was clarified by Federal Reserve Chairman Jerome Powell on March 7th, 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, Chair Powell's comments left the door open to rate hikes greater than 25 bps and a higher terminal value for its targeted rate, which some believed could approach 6.0%, if inflation did not weaken sufficiently.[5] Aside from rate hikes, quantitative tightening (QT) asset sales sales continue to run as planned, with some $600 billion in securities coming off the Fed's balance sheet since mid-2022.

Indeed, the economic data to date in 2023 show that despite the Fed's aggressive efforts, the economy is still too strong—as evidenced by robust new jobs growth and retail sales in January and February—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 6.0% YOY,[6] far above the Fed's 2.0% target. Powell's early-March 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 the likelihood of a hard landing.

Powell's comments on March 7th were sobering news for the many investors who persisted in believing that QT would be ending sooner than the Fed's own stated intentions. These policy intentions might now be on hold thanks to a mini banking crisis that has quantitative easing (QE) 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 have continued to grind lower through mid-March, erasing most gains made since early January. Credit markets have also lost much of their New Year mojo and offer perhaps the most sobering view of the realities of the moment, with 3-month LIBOR rate—the erstwhile benchmark rate for most leveraged loans, breaching the 5% level for the first time since 2007, while the spread inversion between two-year and ten-year Treasuries surpassed 100 bps, its widest spread since 1981 and a highly reliable predictor of recession. The rally in leveraged credit markets to start the year has also faded, with the cost of new issuance and floating-rate debt for many speculative-grade borrowers approaching 10%. Naturally, this is especially bad news for highly leveraged companies.

Recent turbulence in the regional banking sector will probably usher in a period of heightened internal and regulatory scrutiny of current business practices and exposures, capital adequacy requirements for smaller banks and more lending prudence until there is a better understanding of the exact causes of these bank failures. Such conditions would disproportionately impact regional bank lending and their business relationships with start-ups, middle-market companies and smaller PE sponsors, all of whom may face more restrictive access to capital. This can only suppress business activity in these impacted areas.

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 notably 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 monthly from mid-2021 through 2022 and a long-term average of 10.5 since 2010 (**Exhibit 1**). Consistent with recent years, filings to date continue to skew more towards smaller-to-mid sized filers, those with liabilities at filing between $50 million-$150 million, or what generally would be considered middle market companies, while billion-dollar filings remain in relatively short supply but have picked up in March.

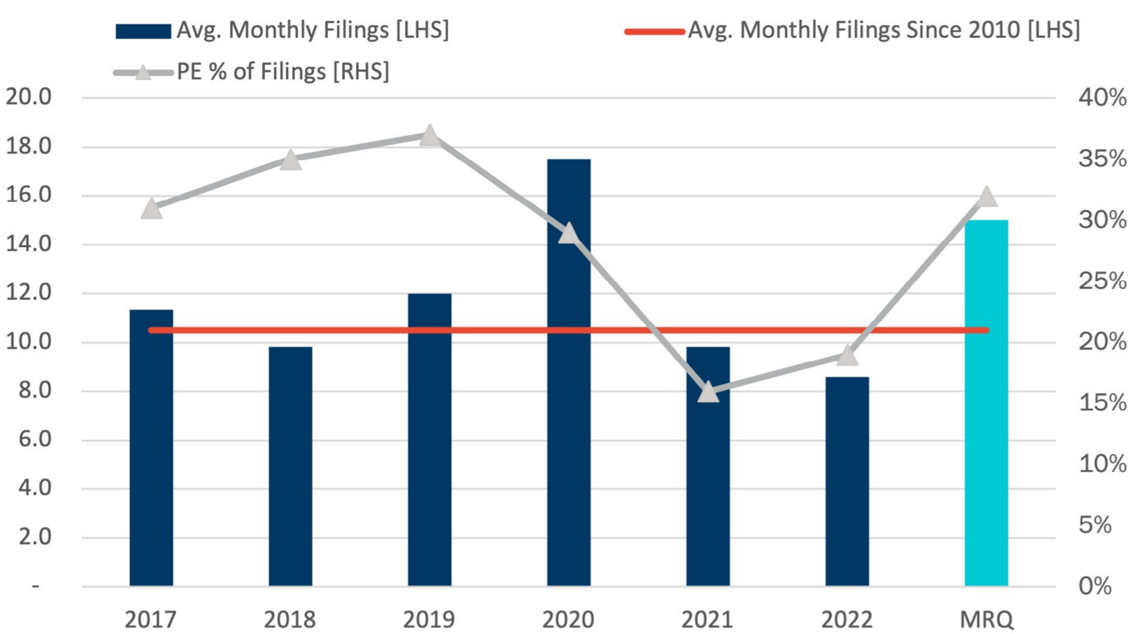
Similarly, S&P rated-debt defaults soared to 23 in January and February compared to 12 in the same period a year ago, with 70% of these defaults being U.S.-based companies. This marks the strongest start to a year for defaults since 2009, according to S&P.[7]

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 three months into this 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 breakneck pace, more or less, for the remainder of the year for 2023 to be considered an exceptionally strong year. That's certainly not out of reach and, if anything, seems more achievable today than it did a couple of 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 very likely versus 103 filings in 2022. This would be the highest 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.

Sponsor-owned companies are really 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 2021-2022 (**Exhibit 1**). 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 PE 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.

Exhibit 1: Monthly Large Chapter 11 Filings



Source: The Deal, FTI Consulting analysis

Endnotes

[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), https://www.cnbc.com/2023/03/14/moodys-cuts-outlook-on-us-banking-system-to-negative-citing-rapidly-deteriorating-operating-environment.html.

[3] Gertrude Chavez-Dreyfuss, “Analysis: Declining U.S. bank reserves add wrinkle to contentious debt ceiling issue.” Reuters (March 13, 2023). https://www.reuters.com/markets/us/declining-us-bank-reserves-add-wrinkle-contentious-debt-ceiling-issue-2023-03-10/

[4] Jeff Cox, “Fed Chair Powell says interest rates are ‘likely to be higher’ than previously anticipated.” CNBC via MSN.com (March 7, 2023), https://www.msn.com/en-us/feed

[5] Davide Barbuscia, “BlackRock sees ‘reasonable chance’ of Fed raising rates to 6%”. Reuters March 7, 2023. https://www.reuters.com/markets/us/blackrock-sees-reasonable-chance-fed-raising-rates-6-2023-03-07/

[6] Paul Davidson, “Consumer price inflation rate slows to 6% in February, but prices post strong monthly gain.” USA Today (March 14, 20230), https://www.usatoday.com/story/money/economy/2023/03/14/cpi-inflation-data-today-live-updates/11443449002/

[7] “Corporate Defaults Reach Their Highest Year-To-Date Total Since 2009.” S&P Global Ratings (March 13, 2023) https://www.spglobal.com/ratings/en/research/articles/230313-default-transition-and-recovery-corporate-defaults-reach-their-highest-year-to-date-total-since-2009-12665116

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