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Silicon Valley Bank collapse

investors should stay calm

'Stay calm because that's what is important....the last thing we need you to do is panic' - Greg Becker, CEO Silicon Valley Bank, 9 March 2023.

When the chief executive of a bank implores their investors and depositors not to panic, it is usually a signal to get out and head for the hills. So it proved with Silicon Valley Bank (SVB); on 10 March the bank collapsed and was in the hands of regulators. Two days later, another sizeable US bank, Signature, was closed by regulators. What does this mean for the financial system, Fed policy and markets?

Why did these banks collapse?

Both grew rapidly and had narrowly focused client bases; SVB specialised in early-stage venture companies, Signature was more broadly diversified with a focus on larger clients and specialist areas, but in 2018 made what was perhaps its downfall, a move into the crypto world, with crypto exposure representing 30% of deposits by 2023. Deposits represented a relatively large proportion of their liabilities, in SVB over 80%, and much of these were uninsured (i.e. deposits greater than $250,000 which are at risk in the event of the bank's collapse), while assets were heavily exposed to investments, typically government bonds and mortgage-backed securities, with commensurately small loan books, especially in the case of SVB. As funding for high-risk smaller tech stocks dried up and the crypto world imploded, both banks suffered deposit withdrawals and were forced into selling securities, crystallising large losses which wiped out much of their equity base and made them insolvent – gradually then suddenly as is invariably the case. Although the concentrated and risky nature of the banks' client bases, and the mismatch of the duration of assets and liabilities, were major factors in their collapse, the dramatic shift from ultra-loose monetary policy to the tightest policy in 40 years, with a deeply inverted yield curve, also played a large part.

How important are these banks?

Bank failures in the US are not uncommon; there have been 563[1] since 2001, but most are tiny, with the biggest during the Global Financial Crisis (GFC). SVB is the second largest to fail, with assets of $211bn (the sixteenth largest bank in the US), while Signature is the third, with a balance sheet of $110bn. For context, the US banking industry has total assets of $23tn, with the largest, JPMorgan, $3.7tn. Importantly, most of SVB's and Signature's deposits are above the Federal Deposit Insurance Corporation's (FDIC) insured threshold of $250,000, therefore exposing substantial amounts to loss.

What did regulators do?

They reacted rapidly and effectively to combat the risks of contagion and bankruptcy of depositors. The institutions were not bailed out, meaning equity holders would be wiped out, but all depositors, insured and uninsured, were given immediate protection in full. The Fed also introduced a new emergency lending facility, the Bank Term Funding Program, enabling banks to borrow from the Fed for up to one year against high quality collateral including US Treasuries and mortgage-backed securities, valued at par, meaning mark-to-mark losses would be avoided, and essentially providing banks with liquidity without needing to sell assets.

Is this a re-run of the GFC?

No, there are no obvious systemic risks arising from the collapses. It could be argued that something would eventually have to give in the face of the steep tightening cycle, but the banks that have failed lacked diversity of both assets and liabilities, and the mis-match between the duration of those assets and liabilities was a failure of risk controls and management. The tightening of regulations post the GFC and more conservative risk management of most banks has resulted in much stronger balance sheets, bigger capital buffers and greater resilience. The speed and extent of the regulators' response to the latest failures goes a long way to minimizing contagion and a wider fall-out.

How did markets react?

Dramatically in the case of bank share prices, bond yields and market expectations for the Fed Funds rate, less so for equities generally. The index for the biggest banks in the US fell by 18% in the seven trading days to 13th March, while smaller regional banks fell by 25%. Bank share prices around the world fell equally sharply. Bond yields, which had risen sharply in February, reacted with steep falls; the US 10Y Treasury moved from a yield of almost 4% to 3.5% within three days while the 2Y Treasury yield fell remarkably by over 100bps from 5% to just below 4% as expectations for the path of the Fed Funds rate shifted substantially. Real yields fell sharply, to 1.3% on 10Y bonds from over 1.6%, while inflation break-evens fell to around 2.25% from 2.5%. The market rapidly priced in a lower terminal rate and early cuts in the Fed Funds rate, with a 2023 year end level of 4% compared with expectations of 5.5% only days earlier. Broader equities were relatively resilient, the S&P falling by close to 8% from the peak in February and wiping out virtually all its gains year to date, although still leaving the market up by 8% from its October 2022 low. The US dollar weakened by 2% and gold rose by 5%.

Will economic activity be damaged?

While this is not a systemic event, banks going bust is never healthy or growth-enhancing. Banks are the cornerstone of economies and when confidence in them is damaged the knock-on effects can be deflationary and significant. In this case the numbers are not large in terms of assets and depositors, and the regulators have done a good job in preventing wider contagion, but nevertheless it will make fund-raising more difficult for the type of early-stage tech companies that banked with SVB, at a time when raising equity capital is extremely difficult if not impossible in private markets. The competition for deposits among smaller banks will probably intensify, raising the cost of capital and damaging margins, while banks will be tightening lending terms. At the margin, then, growth is likely to be damaged, but of more concern is the extent to which the steep tightening cycle will result in further casualties. It would be an extremely unusual cycle if this were not to be the case, those industries and companies with the greatest leverage likely to be most exposed.

What does it mean for Fed policy?

It makes the Fed's job more difficult. Growth and inflation have been above expectations this year and a tight labour market along with sticky inflation is causing concern among policymakers. But the demise of banks is potentially deflationary and signals contagion risks and wider problems resulting from tight and expensive money. The Fed's main task is to bring inflation under control, but monetary policy acts with long lags and the risk of overkill has been heightened. The market could have gone too far in its immediate reaction to the bank failures, but the terminal Fed Funds rate is now likely to be lower than the 5.5% or thereabouts that the Fed had previously flagged, and rate cuts might come earlier, possibly before year end. Events of the past week will probably help in bearing down on inflation and lead to an earlier end to the tightening cycle.

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What should investors do?

Do what Becker, now the former CEO of SVB, implored his depositors, stay calm and don't panic (which they plainly ignored). This is a troubling turn of events, but it is not systemic and the risks of contagion across the banking industry are extremely low. There are headwinds: we are in one of the biggest monetary policy tightening cycles in history and it is inevitable that this brings increasing challenges for businesses, consumers and the economy in general, with considerable pain for those exposed to high levels of leverage. Private markets will remain challenged for some time, and parts of the commercial property market are vulnerable. Recession risk is real and heightened by recent events. But we are over the peak in inflation and it is likely that both headline and core inflation will fall sharply through 2023. Interest rates are also very close to a peak, and before too long markets will look through to rate cuts and a recovery in economic activity in 2024. With the heightened uncertainty and huge rise in volatility in the past week, especially in bond markets, it is prudent to let things settle down in the very short term. The much-improved valuation opportunities in government bond markets that opened up during 2022 and early 2023 have been partially reversed, while equity markets have proved to be relatively resilient. We are therefore content to hold cash and shorter duration government bonds while waiting for opportunities in longer duration bonds and equities during periods of weakness, which are likely in the weeks ahead.

Important Notes

Source of all data Bloomberg Finance L.P unless otherwise stated. [1]Deutsche Bank.

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