US Banking Stress
Silicon Valley Bank Update

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strategicwealth

You may be aware of news headlines linked to US regional commercial bank, Silicon Valley Bank (SVB). The bank had been under pressure due to deposit outflows over recent weeks. Those pressures intensified rapidly last week when SVB faced a 'run' on deposits which impacted solvency and led to SVB being placed into receivership.

To help you understand this event and where it might head, we have attached a summary of the situation and the potential responses that may be taken by the US Banking Regulators.

There may be further volatility in coming weeks and months as investors digest the policy response and assess any further investment implications.

Events like this can create buying opportunities for clients with excess cash and long-term investment horizons. However, it is too early yet to make that call and we will see what develops in the short term.

Kind regards,

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Introduction

You may be aware of news headlines linked to US regional commercial bank, Silicon Valley Bank (SVB). The bank had been under pressure due to deposit outflows over recent weeks. Those pressures intensified rapidly last week when SVB faced a 'run' on deposits which impacted solvency and led to SVB being placed into receivership.

What do we know so far - Recent Events leading to SVB being placed into 'receivership'

Silicon Valley Bank (SVB) is a US Commercial regional bank, the 16th largest in the US with about US$210Bn and listed in the S&P500. SVB's business was heavily focused on the US technology sector with a particular focus on start-ups which represented a large proportion of the depositor base. As US interest rates rose over recent months, the bank experienced a greater than expected deposit outflow - likely from some technology clients needing liquidity as private capital became more expensive and possibly as some depositors saw the opportunity for better yields elsewhere.

To meet deposit outflows, the bank was forced to sell financial assets. These assets were predominantly low risk US government and agency bonds. The rise in bond yields over the past 18 months meant the market value of those bonds had declined. Selling the bonds meant realising losses which added to balance sheet pressures. SVB came under more extreme pressure last week and attempted to raise capital to shore up solvency. The attempted US$2.25bn capital raising failed and depositor flight intensified, with reports depositors tried to withdraw circa $42bn on Thursday alone.

SVB's share price opened 33% lower on Thursday, the stock finished down over 60% by the end of the day, and the shares were halted early Friday. The Federal Deposit Insurance Corporation (FDIC) stepped in to place SVB in receivership on Friday night.

The demise of SVB was a classic 'bank run'. Reduced faith in the bank led to mass depositor withdrawals that could not immediately be met with cash on hand or by selling liquid securities without impacting solvency.

A major issue appears to have been the duration mismatch between high quality government bond assets and short-term deposit liabilities.

SVB Specific Vulnerabilities

The demise of SVB appears linked to some specific SVB vulnerabilities.

- SVB business was extremely concentrated in a narrow industry segment (Silicon Valley tech). This industry segment appears to have represented a large share of SVB's total deposit base while traditional 'stickier' retail deposits represented a smaller proportion of total deposits than is the case with other banks.

- SVB was also reported to hold a much higher ‘loan to deposit’ ratio relative to competitor banks.
- SVB’s Loan book was reportedly composed primarily of private equity linked credit lines and loans to technology companies.
- It appears that SVB invested in longer term securities and appears to have not hedged much interest rate risk of holding these securities. This made SVB particularly vulnerable to potential capital shortfalls in case of rising interest rates, deposit outflows and forced asset sales.

Broader Banking Context

There are certainly some factors that affected SVB that will be common to other banks (losses on large holdings of US Treasuries and US Agency Mortgage bonds).

The critical question in the minds of investors is whether SVB being placed into receivership points to broader risks in the US banking sector.

The immediate answer to that question, at least in terms of other regional banks in broadly similar circumstances to SVB, is ‘Yes’.
A second US regional bank, Signature Bank was closed by regulators in the US earlier today (Sunday US time). The bank had $110 billion in assets, and $88.6 billion in deposits as of the end of 2022. By deposits, it was the 30th biggest bank in the U.S. last year.

Between Q4 2019 and the first quarter of 2022, deposits at US banks rose by over $5 trillion as depositors were flush with cash whilst demand for loans remained relatively weak. For some banks, particularly regional banks with concentrated business lines such as SVB, only a small proportion of that money was lent out. The rest was invested in securities portfolios or kept as cash.

A key question for investors relates to how much duration risk did each bank take in its investment portfolio during the deposit surge. i.e. How much was invested at lower treasury yields than today’s and what tenor were these securities? This information can be difficult to extract from just looking at standard financial disclosures.

Bank failures, whilst ‘rare’ in terms of percentage of the industry, are not totally uncommon. Several US regional banks have ended in receivership each year over the past decade. The past week’s events however certainly justify investor concern about specific risks for other banks and directly impacted businesses and investors. Those impacts can be addressed by the relevant authorities.

We highlight also that the regulation applying to big banks, the ‘Globally Systemically Important Banks’ (GSIBs) is more stringent and is designed to ensure strongly capitalised and diversified to withstand almost all market environments.

What’s Next - Policy Response

US banking regulators with the support of the Treasury Department are already taking extraordinary steps to manage the risk of contagion and adverse economic impact.

The typical SVB depositor was not one insured by the FDIC, which only insures deposits up to $250,000.

About 93% of SVBs deposit base would have been uninsured and so the risk of a broader deterioration in depositor confidence was high should SVB depositors not be protected.

A joint move by the Federal Reserve and Treasury Department has however taken the extraordinary step of designating SVB and Signature Bank as a risk to the financial system, giving regulators flexibility to backstop uninsured deposits.

The US Fed has announced an emergency meeting for Monday with the likelihood of further liquidity programs to shore up the US banking system to make sure contagion is limited.

Market Response and Strategy Implications

So far, the market response to SVB and Signature bank being placed into receivership has been most pronounced in large share price falls for several of the small and mid-sized US regional banks.

The other major flow through has been to interest rate markets where expectations of future policy tightening have been revised lower and government bond yields have fallen sharply.

Many commentators have noted that the fastest policy tightening in decades raises the risk that “something breaks”. That’s not so much a speculation as it is an observation of history that as the long high tide of cheap and plentiful liquidity runs out, areas of excess and risk will usually be exposed. The current cycle looks very unlikely to be different.

There may be further volatility in coming weeks and months as investors digest the policy response and assess any further investment implications.

We will continue to monitor the situation and update you on any significant developments.

Important Information

General Advice Warning