AHAM CAPITAL
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FUNDAMENTAL FLASH

Unpacking the Collapse of Silicon Valley Bank

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What happened?

US equities reeled from the fallout of Silicon Valley Bank (SVB) last week as contagion fears spread within Wall Street. The lender which extends loans primarily to start-up and technology companies faced a cash crunch as it was forced to realise losses in its bond securities.

At its heydays in 2015, SVB served 65% of all US start-ups and it grew rapidly alongside the technology sector. Its growth was turbocharged by a low interest rate environment where funding was abundant.

During this time, its deposits grew from US$44b in 2017 to US $189b in 2021. Its loans also grew from US$23b to US$65b in the same time-period.

With an abundant of deposits over loans, SVB had placed them into available-for-sale and held-to-maturity securities like Treasuries and mortgage-backed securities when yields were at all-time lows.

However, as interest rates began to rise rapidly in 2022, it recorded massive outflows in deposits alongside the rest of the banking sector.

For context, the banking system saw four quarters of deposit outflows last year; whereas there only had been 10 quarters of outflows in the past 50 years. This torrent of deposit outflows impacted SVB proportionally higher due to its focus on the technology sector.

Flashpoints

- The collapse of Silicon Valley Bank (SVB) has triggered contagion fears within Wall Street as depositors scramble to withdraw funds.
- Smaller US banks caught in the turmoil include Silvergate and Signature Bank which have exposure to blockchain and cryptocurrency related corporates.
- US regulators have since stepped-in to introduce backstop facility measures for depositors as well as bank term funding.
- Base-case is that this would not lead to a systemic financial risk like that of the 2008-GFC. The latter stemmed from credit issues, while SBV's case relates to a mismatch of duration.

To accommodate the outflows, SVB sold substantially all (US$21b) of its available-for-sale securities. This incurred a US$1.8b loss and impacted its regulatory capital position which then forced the bank to raise capital. When SVB unveiled its plan to raise US$2.2b capital, the announcement spooked markets and started a bank run which ultimately led to its collapse.

It is worth noting that SVB had marked-to-market losses of US$16b as of September 2022 for its held-to-maturities securities compared to its tangible equity of US$12b.

Were other banks impacted?

Smaller US banks caught in the turmoil include Silvergate and Signature Bank which saw depositors fleeing in droves. Both banks are unique in that its focus are on providing banking services to blockchain and cryptocurrency related corporates.

Their collapse was partly due to clients scrambling to redeem deposits in the wake of the FTX cryto-exchange scandal as well as panic from the collapse of SVB.

Have regulators taken action?

Over the weekend, US regulators have stepped-in to introduce backstop facility measures for depositors.

In a joint statement, the US Treasury Department and other bank regulators said that all depositors of Signature Bank and Silicon Valley Bank will be made whole regardless of how much they held in their accounts.

In addition, US regulators have also created a new Bank Term Funding Program (BTFP) to help safeguard depositors and curtail risks in the banking sector. The facility will offer loans of up to one year to US banks, where they would be asked to pledge high-quality collateral such as Treasuries, agency debt and mortgage-backed securities.

According to the announcement, these securities will be valued to full par value. This source of liquidity would eliminate an institution's need to quickly sell those securities in times of stress.

What are the risks of another global financial recession (GFC)?

Our base-case is that the implosion of SVB is unlikely to lead to a systemic financial risk like that of the 2008 global financial recession (GFC).

The collapse of SVB was due to a duration mismatch between high quality assets (Treasuries and mortgage-backed securities) and deposit liabilities.

In contrast, the 2008-GFC stemmed from credit issues as banks held exposure to toxic assets of mostly subprime mortgage-backed securities. Abundant liquidity and lax lending had fuelled a housing bubble. When it ultimately burst, banks were left holding trillion of dollars of worthless investments in subprime mortgages which led to the financial crisis.

Lessons from the 2008-GFC have since then resulted in tighter regulations especially for bigger banks and the rest of the broader banking sector well capitalised. This coupled with the US regulator's backstop facility measures mentioned above will ensure the crisis remains contained.

How frequently do US banks fail?

Between 2008 to 2012, 465 banks failed with total assets of US$700bn.

More recently between 2018 to 2020, we saw 8 banks collapsing with total assets of US$672b (vs. SVB's ~US$200b). There are over 4,700 banks operating in the US banking sector.

How is the US Federal Reserve (Fed) likely to react?

While the implosion of SVB is unlikely to spark a financial crisis, the financial episode does expose the vulnerability of certain sectors as interest rates rise rapidly. This is something that the Fed would take into consideration in future policy meetings.

Market expectation of terminal rate has adjusted lower to 5.1% in the wake of the SVB news. However, as the dust settles, we believe markets will shift its focus back to inflation and job data.

Recent remarks by Fed Chair Jerome Powell suggest that the Fed could shift its terminal rate higher from currently 5.125% at its upcoming FOMC meeting on 22 March.

How are we positioning our portfolios?

None of our equity or fixed income portfolios have any direct exposure to SVB.

US stock futures are seen climbing today as markets react positively to the slew of measures taken by regulators to shore up the financial sector.

A key point to monitor is whether the collapse of SVB would pose any significant dent to confidence and lead to a decline in consumption. This could hasten a slowdown in economic growth as the impact of monetary policy also begins to bite.

We maintain our constructive view on bonds as much of the future rates hikes have been sufficiently priced-in by the market. For equities, we remain positive on Asia as China's reopening provide tailwinds to the region and support growth.

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