

Assessing the Silicon Valley Bank fallout

A troika of the Fed, Treasury and regulators stepped in over the weekend to help calm nerves in the wake of the SVB collapse. We show that SVB is an outlier in many ways, but it is too early to call the all-clear on the sector; it's a risk from the aggressive rate-hiking environment. So far the system looks fine, but it needs to be treated with caution ahead, just in case



Silicon Valley Bank, the 16th largest bank in the US, has collapsed

Eerie echoes of the global financial crises, but also material differences

The demise of Silicon Valley Bank was fast, super fast. It started on Wednesday as SVB took a US\$1.8bn loss on a forced USD\$21bn bond liquidation from its available-for-sale portfolio; it then announced an intention to raise US\$2.25bn in capital to help plug the gap. Thursday then saw material deposit outflows, and the SVB stock collapsed. Inevitably, with trust gone, Friday saw SVB go down. The regulators stepped in, with the FDIC acting as the receiver in a clean-up exercise. An attempted auction process began over the weekend, seeking suitors.

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There has already been a degree of market contagion, on fears of replication in other banks. All banks hold securities, for various reasons. In the traditional banking model, deposits raised are used to underwrite loans. Banks have the option to invest in bonds as an alternative to writing loans, and this is most applicable where, for whatever reason, there is either not enough demand for loans, or the terms on writing loans are less appealing. Unusually, SVB employed far more of its deposit base in long-dated bonds than in writing loans. This meant it was more susceptible than most banks to the performance of its bond portfolio.

Moreover, SVB's bond portfolio had a large longer-dated fixed-income component. As rates rise, the value of this portfolio fell. This would damage the running yield on such a portfolio, pressuring the implied interest rate margin down. Under pressure, liquidation of the bond portfolio crystallised losses, necessitating the subsequent need to raise capital. Banks that hold either a lower proportion of bonds to loans (most do) and/or hold more of their securities in floating rates would be far less susceptible to an SVB-type repeat.

The Federal Reserve and Treasury are ahead of the game just in case

But that does not mean that there aren't other SVBs out there. Treasury Secretary Janet Yellen in fact alluded to the possibility that there may indeed be some, as she noted on Friday that the Treasury was monitoring some other banks. So far, it seems that the potential problem banks are few, and importantly do not extend to the so-called systemically important banks. But even if that's the case, there is still a fear that contagion risks are uncomfortably elevated. In the end, the banking system is a game of trust. So there needs to be some assurance that system breakdown risk is low.

But crucially, we have assurance that system breakdown risk is low

To help achieve that outcome, a joint statement by the US Treasury, the Federal Reserve and the FDIC over the weekend announced that SVB "depositors will have access to all of their money starting Monday, March 13". They went on to state that "we are also announcing a similar systemic risk exception for Signature Bank, New York, which was closed today by its state chartering authority. All depositors of this institution will be made whole". This is a clear effort to calm nerves and ensure that we don't have depositors queueing outside other banks that might come under scrutiny ahead. The statement outlined that shareholders and certain unsecured debtholders will instead not be protected.

The Federal Reserve also announced the creation of a Bank Term Funding Program as a means for banks to backstop deposits. Basically, this is a facility that provides collateralised liquidity for banks that can't obtain it elsewhere. The new funding programme offers loans of up to one year in length against high-quality collateral valued at par including US Treasuries, agency debt and mortgage-

backed securities, and other qualifying assets. The purpose is to eliminate the need to sell those securities in times of stress to obtain liquidity. Note that if these securities are meant to be held to maturity, utilising the funding programme would not create a need to fair value these securities. Most can already access the discount window for liquidity purposes. The federal funds rate is the primary credit programme for banks. But there is also a secondary credit programme where liquidity can be accessed at a more penal rate. Basically, the additional programme is a means to making liquidity available on good terms, at least until the current period of elevated systemic pressure passes.

The system is under scrutiny, but fine so far. But the Fed now needs to be careful

One of the reasons that the Federal Reserve could deliver fast and impactful interest rate increases over the past year is that the system could take it. Equity markets and bond markets may have crumbled, but as long as the system was intact the Fed could continue to tighten. The SVB saga as a stand-alone mutes the ability of the Federal Reserve to over-tighten from here, as there is an implied threat to the system should the Fed be seen to be overdoing it.

Risk barometers like FRA/OIS and the cross-currency basis have spiked, but not dramatically so. This suggests the system has had a wobble but is absolutely not under immediate threat. But, the down move in the yield curve (curve has shifted lower by 40bp) points to a material reduction in the likelihood that the Fed overdoes it on rate hikes. The 50bp March hike that Chair Jerome Powell had managed to build last week is gone; it's now 25bp.

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We argue that what equity markets do here is not that relevant. They can come under pressure, but the really important thing to monitor is the financial system. If that were to be materially threatened, put simply, the Fed could not hike at all. We only have to look at the global financial crisis and the pandemic as templates that showed the Fed is single-minded when the system is under threat, and that is to cut rates and ease policy, significantly.

We are not at that point, and we most likely won't get to that point. But if the inflation data refuses to dampen in a material fashion it places pressure on the Fed to make a tough choice. The simplest choice is to stick with 25bp, and let the market calm down of its own accord in the weeks and months ahead.

We need to accept that some banks will come under pressure at this stage of the interest rate cycle. The Fed has hiked from zero to near 5%. Moreover, starting from zero rates means a bigger rate sensitivity to hikes (think duration). If some balance sheets get eroded by a ratcheting down in market valuations, and become an eyesore, before you know it there are trust issues to deal with. Big banks are less affected; they have to meet tougher hurdles to begin with. But there could well be further stress in the smaller bank sector.

This could and indeed probably should all blow over. But we need to also let a bit of time pass before we can be sure.

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