JBWere

The CIO Express

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Putting Wealth To Work For Generations

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The CIO Express – Thoughts on recent developments in the US banking sector

What happened?

On Friday, US regulators (the Federal Deposit Insurance Corporation) took control of Silicon Valley Bank (SIVB) and placed it into receivership. This is the largest US bank failure since Washington Mutual in 2008.

Why did it happen?

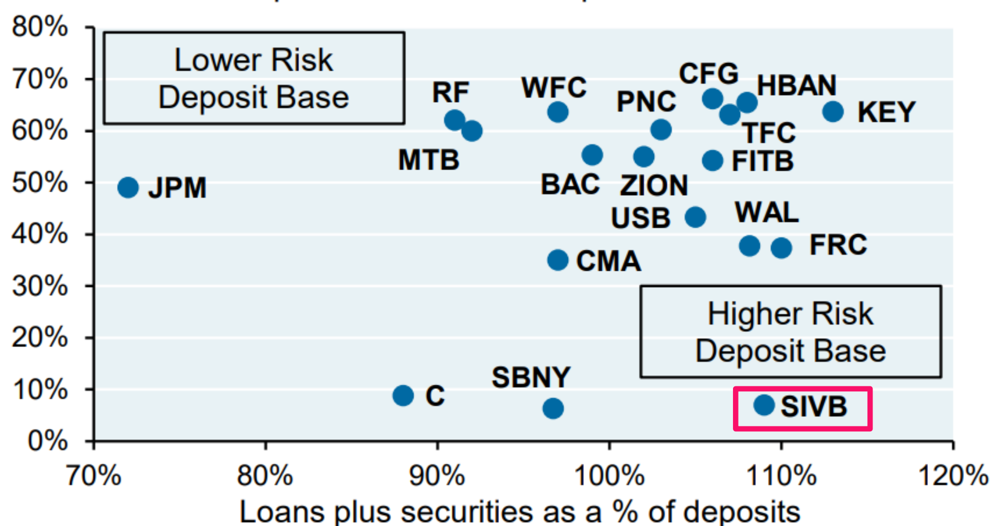
SIVB was a bank with very high geographic and customer concentration; it effectively exclusively banked the US West Coast tech sector. This meant it had a very undiversified deposit base; few retail investors, many business deposits, all from the same industry and region.

As the Fed lifted interest rates and funding costs rose, many of the tech start-ups banked by SIVB found it increasingly difficult to obtain funding from traditional sources (such as Venture Capital funds). They started to draw on cash deposits instead. Reports suggest that SIVB lost ~USD20bn in deposits in 2022. This process – deposit drain – accelerated in 2023.

In order to facilitate these deposit withdrawals, SVB had to sell bonds from its “Hold to Maturity” (HTM) portfolio. SIVB held a large amount of bonds because somewhat unusually, it didn’t lend very much of its deposit base. Instead, it invested excess deposits in fixed income securities. Unfortunately, many of these bonds were purchased at very low interest rates, exposing the bank to a significant risk of loss if interest rates rose. Somewhat unusually, SIVB appeared not to hedge any of this interest rate risk.

The chart below, from JPMorgan Asset Management, shows the rather unique balance sheet characteristics of SIVB.

Chart 1: Silicon Valley Bank was something of an outlier



Source: JPMorgan Asset Management.

The problem with selling bonds from the HTM portfolio is that once the bonds are sold and losses realised, the HTM portfolio has to be marked-to-market. Losses on the portfolio reduce the bank's equity capital base. So last week, SIVB announced a USD2.25bn equity raising in order to cover USD1.8bn in losses from the sale of a USD21bn fixed-rate security portfolio. The attempt to raise equity was unsuccessful, and hence regulators took control of the bank.

As an aside, SIVB could "get away" with what most would regard as sub-standard risk management due to a regulatory change in 2018. This change deemed that systematically important banks were those with $250bn of assets (the prior threshold was $50bn of assets). This meant SIVB did not have to adhere to a strict regulatory regime around liquidity management, interest rate hedging and capital management. Larger, systematically important banks in the US are subject to a far more rigorous regulatory regime which protects – to an extent – against events such as occurred at SIVB.

Observations and Implications

In many respects, this is not a usual bank failure. Normally, banks fail due to credit issues which negatively impact asset quality (the loans they issued are unable to be repaid). This time, the bank failed due to a combination of **1)** geographic and industry concentration; and **2)** asset and liability mismatch (long duration assets vs. very short duration liabilities).

However, regardless of the cause of the failure, there are some important observations we can make. **First, the root cause of SIVB's failure was the rising cost of capital**. As less money flowed into VC funds (in a rising yield environment there are other attractive risk-adjusted alternatives), funding for tech start-ups became harder to obtain. This prompted the run on deposits at SIVB. In our view, SIVB wasn't the first and is unlikely to be the last casualty of a materially higher cost of capital. The Fed's aggressive tightening cycle has punctured a number of "bublets" since it began (for example crypto-currencies, "YUCs" [young unprofitable companies] etc.) But from a portfolio management perspective, the sustained lift in cost of capital across in the past year has been one reason why we have recommended company specific exposures be limited to those with low levels of leverage and experience in managing revenues and profit through the cycle.

Second, there will be runs on other smaller banks and distress in the tech start-up sector. Depositors in the US have deposit insurance up to USD250k, but many institutions have deposits well beyond that level. These deposits are likely to find their way to larger

systematically important banks, at the expense of smaller regional US banks. Tech companies with uninsured deposits at SIVB (reported to be in the order of 97% of deposits) will experience cash flow issues as a consequence of SIVB's failure. This will, in some (possibly many) instances, render them illiquid and possibly insolvent. However, news early this morning has suggested that US officials are keen to "meet the needs" of all depositors.

Third, Venture Capital (VC) and Private Equity (PE) funds who have invested in the tech start-up sector will find themselves the subject of intense scrutiny as valuations in that sector are called into question. Media reports over the weekend have established that there are VC funds in Australia with investments in companies that have cash deposits at SIVB. Financial markets are fully globalised and we should expect that there will be some regional ramifications.

Fourth, markets will remain in risk-off mode, wary of further headline risk and nervous about movements in front end funding spreads in US dollar markets. That recent developments in the US financial system come just after the Federal Reserve Chair had delivered hawkish comments on the outlook for US interest rates is remarkable and shows how quickly events can impact the outlook. Already, the market has pared back its expectation for the next FOMC meeting (on 23 March) from expecting an 86% chance of a 50bp rate hike to now pricing a 66% chance of a 50bp rate hike. Tuesday's US inflation data will be key.

Finally, and despite the challenging macro backdrop at present, we know that for any central bank, **financial stability trumps all**. In this regard, we would expect US regulators to make clear distinctions between current events and those that transpired in 2008. We would also expect any statements from US regulators to focus upon shoring up confidence in US banks and the broader banking system, and to announce a solution to the problem at hand soon. US Treasury Secretary Yellen noted over the weekend that "I've been working all weekend with our banking regulators to design appropriate policies to address this situation."

Conclusion

At this point, it is hard to know whether recent developments represent a tiny crack or a major fracture in the US financial system and economy. We have penned these comments with the understanding that developments are likely to move quickly and hence the relevance of the above analysis to the near-term outlook for financial markets, economy and monetary policy is likely to be short-lived.

However, we think that there are a number of implications that will sustain regardless of developments in coming days; namely **1)** valuation pressures for sectors, companies, and asset classes that are vulnerable to structurally higher interest rates and / or cost of capital; **2)** a shift in the distribution of risks around economic growth in the US to the downside as the ramifications of SIVB's collapse are fully understood; and **3)** a potential rethink about the likely duration of the Fed's tightening cycle and balance sheet shrinkage.

Assuming we are correct in our sense of what pressures will continue to bear on the US financial and economic outlook, **we remain of the view that defensive positioning is the correct approach to portfolio construction at present**, both at an asset allocation level and at an asset class level.

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