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focus

The Chips Are Down:
Silicon Valley Bank Failure

The collapse of Silicon Valley Bank over the weekend was the biggest US bank failure since the Global Financial Crisis. The bank was the 16th largest bank in the US and had branches across the world, including in the UK, China, Europe, India, Canada, and Israel. Regulators have jumped in with efforts to prevent contagion across the banking sector and economy. We expect the implications for the broader economy are modest, however, it does highlight that when interest rates rise sharply after being at extreme lows for more than a decade things can break. Investors should stay vigilant.

FORSYTH BARR

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All their eggs in the tech basket

Silicon Valley Bank (SVB) was a commercial bank headquartered in Santa Clara, California, the heart of Silicon Valley. The bank was established in 1983, and while it didn't solely service technology companies its customer base was concentrated in the sector as well as life sciences, healthcare, private equity, venture capital, and premium wine industries.

SVB's customers were not well diversified. That concentration meant SVB benefited from strong deposit growth over the past few years as early-stage companies took advantage of buoyant markets to raise a lot of capital from venture capital firms, initial public offerings (IPOs), and other investors. More recently, however, with market conditions more subdued, SVB's deposits started to decline as capital raisings dried up and its early-stage company customers consumed cash.

A second challenge for SVB was that it had invested over half of its deposits (a much higher portion than most banks) in fixed income securities, most of which were long-dated bonds bought at previously very low interest rates. The substantial lift in interest rates means those bonds are worth significantly less today than what they paid for them. Unrealised losses (and gains) on fixed income securities are common in banks and typically even out over time. What was notable about SVB was the magnitude of the losses relative to its equity.

What triggered the crisis was SVB's attempt to re-balance its fixed income portfolio — swap some of its low yielding, long-term bonds for higher income, shorter-term bonds. To do this SVB sold US$21 billion of its long-dated US Government bonds crystallising a US$1.8 billion loss at today's values. SVB sought to cover this hole by looking to raise around US$2 billion of fresh equity capital.

An old fashioned bank run

Bank runs typically happen when a large number of customers withdraw their deposits within a short period of time, usually due to concerns about the bank's solvency or ability to repay its depositors. Bank runs can occur for justified or baseless reasons. (There's a famous story of a bank run in Hong Kong caused by a long line outside a pastry shop which just happened to be next to a bank. People assumed the line was depositors withdrawing their money, word spread, and a bank run was off and running.) A sudden rush of withdrawals can quickly deplete a bank's available cash reserves, leading to a liquidity crisis and potentially the bank's failure.

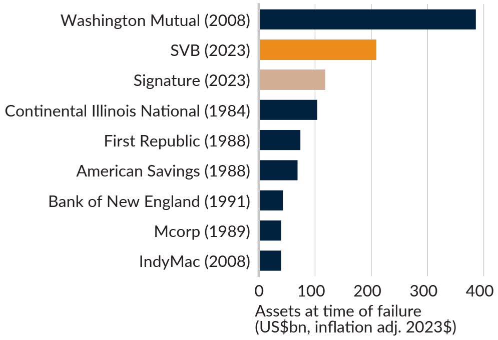
The combination of leaking deposits and SVB's need for new equity led some SVB customers to question the financial stability of the bank. An old fashioned bank run ensued. SVB was more susceptible to a run than most other banks. The US has a deposit insurance scheme which guarantees customers deposits if a bank fails, but only up to a limit of US$250,000 per customer. Most of SVB's customers were companies – 93% of deposits were above the threshold and, therefore, uninsured. Several high-profile venture capitalists reportedly advised their portfolio companies to move their funds out of SVB. Customers attempted to withdrawal US$42 billion in a single day — a quarter of the bank's total deposits — SVB wasn't able to meet these requests. SVB's shares plunged 60% on the news.

Panic ensues; regulators step in

In less than 48 hours SVB was officially bust. Last Friday, the Federal Deposit Insurance Corporation (FDIC) — the US banking regulator — declared it insolvent and took control. SVB is the second largest bank failure in US history, and first major collapse since the Global Financial Crisis (GFC).

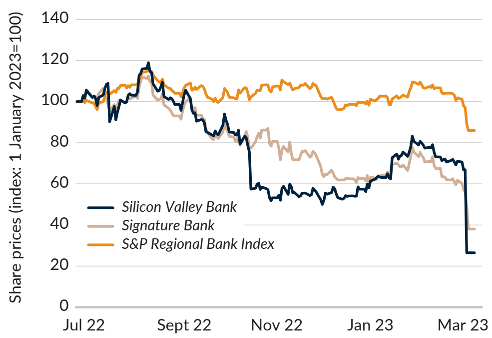
The news saw investor concern spread and the share prices of other regional and mid-sized US banks plunged. On Sunday night, US officials announced that they would also be shutting down another bank, Signature Bank — which has focused on the crypto industry. Shares in Signature had fallen over 20% on Friday.

SVB AND SIGNATURE ARE TWO OF THE BIGGEST US BANK FAILURES IN HISTORY



Source: FDIC, Forsyth Barr analysis

BANK SHARE PRICES HAVE PLUNGED



Source: Refinitiv, Forsyth Barr analysis

Regulators acted swiftly to shore up confidence. The US Treasury, FDIC, and Federal Reserve (Fed) stated that they are "taking decisive actions to protect the US economy by strengthening public confidence in our banking system".

The deposit insurance scheme was extended above the US$250,000 limit to cover all SVB and Signature funds. This alleviated fears that many tech companies would struggle to pay their wages and bills. A number of New Zealand companies have publicly announced they had deposits with SVB — Rocket Lab, ikeGPS, Xero, Comvita, portfolio companies of venture capital firm Icehouse Ventures ... they will have all breathed a huge sigh of relief!

The Fed also introduced a new lending facility called the 'Bank Term Funding Program' (BTFP). The facility will provide loans to banks for up to one year, pledged against collateral such as US Government bonds and mortgage-backed securities.

The important feature of BTFP is that it will recognise the value of this collateral at par (or face value). Par is the value at which a bond is issued, and is the amount bondholders will receive when it matures. In the interim, however, a bond can trade at a discount to par when interest rates rise and the income that the bond pays becomes less attractive to investors. The reason why the Fed is allowing banks to pledge these bonds at par is to prevent them having to 'fire-sale' current discounted assets to meet depositor withdrawals.

This BTFP facility is aimed at preventing contagion across the banking sector. Even if banks were economically sound, companies may have decided to prudently shift their funds out of the small and medium-sized banks to the large, heavily regulated institutions such as JP Morgan or Bank of America. Further bank runs could have followed.

Officials are now looking for buyers of the SVB and Signature assets. So far the only publicly reported deal has been HSBC purchasing the UK arm of SVB for a symbolic £1.

What does it all mean?

SVB and Signature's failures have caused market volatility, particularly among bank stocks. High quality bond prices have risen (and interest rates have fallen) as some investors have sought safe haven in low risk assets.

There are concerns about what other banks might be vulnerable and whether there's a systemic risk across the banking system. We believe a fully-fledged financial crisis is unlikely. Banks' balance sheets are in a much stronger shape than they were heading into the GFC, including significant capital buffers in place for those deemed systemically important. The tech-concentrated nature of SVB's deposit base is unique, and the Fed's BTFP facility removes the risk of banks having to fire-sale assets at discounts to par. Longer-term, additional and

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more costly regulation could be imposed on banks — at very least the additional FDIC insurance will be paid for by levies on the banks (not the taxpayer).

Questions are also being asked about the implications for future interest rates hikes. Some forecasters have lowered their expectations. This is possible but inflation does remain very elevated — it's not a straightforward choice for central banks. The Fed's BTFP programme should insulate the risk of higher interest rates on banks' asset values, giving it further scope to raise rates (the Fed has previously said that it would continue lifting interest rates to fight inflation and deal with any financial sector fallout with more targeted tools).

More broadly, what the collapse of SVB and Signature does highlight is when interest rates rise sharply after being at extreme lows for more than a decade it exposes vulnerabilities. As Warren Buffett says, "only when the tide goes out do you discover who's been swimming naked". Through such periods investors need to stay vigilant, not take undue risk, and stick to a long-term investment plan. Equally, they need to avoid overreacting to disconcerting headlines and market volatility. It's always important to remember, the reason why investors earn a higher long-term return from investing in riskier assets like stocks is because they have to endure volatile periods like these along the way.

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If at any time you wish to discuss current market events or the composition of your portfolio, your Forsyth Barr Investment Adviser is available to provide advice and assistance.

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