REPERCUSSIONS OF THE SILICON VALLEY BANK FAILURE ON FINANCIAL BONDS

In light of the Silicon Valley Bank failure, our strategy acknowledges that we may well enter a short-term period of market volatility but will continue to be assured by the strength of the balance sheets of the financial names we hold in our clients' portfolios.

BACKDROP

The 16th largest US bank, Silicon Valley Bank (SVB), was declared insolvent on Friday 10th March and its day-to-day operations have now been taken over by a government operator called the FDIC.

It is the 2nd largest failure in US banking history.

- The San Francisco bank was the “go-to” bank for the tech-heavy Silicon Valley industry, and saw significant corporate deposit inflows over the past 2 years as the number of start-ups flourished. This led to a significant surplus of deposits on the balance sheet when compared to the bank’s loan book.

- Normally this excess amount of money is invested in sub-12-month fixed income instruments such as short-dated US government bonds. The management at SVB, however, took a market view over the last 2 years to extend the duration profile of the fixed income book into much longer maturities. 2022 was a challenging year for global bond markets, and as yields rose sharply there were significant mark-to-market losses in the excess portfolio book.

- The past 2 quarters have proved to be a more difficult environment for the tech industry, leading to many corporates needing to draw down deposits held at SVB. The accumulating withdrawals, accelerated by the close-knit community of the tech investor deposit base, required the bank to sell part of its fixed income portfolio, resulting in realising a $1.8bn loss. This came out of the bank’s core equity tier 1 which is looked upon as its capital, and in an attempt to replenish this, SVB planned an equity capital raise of $2.3bn which proved unsuccessful. The FDIC subsequently took over the stewardship of running the day-to-day operations of the bank.

- A significant portion of customer deposits were not insured, so panic prevailed within the local industry as companies were not granted access to their deposits to pay for operational expenditures.

OUR TAKE

- We don't believe that the banking system is facing a liquidity crunch.
- Our bank exposure is limited to G-SIBs[1] (Globally Systemically Important Banks as defined by the banking regulator) and national champions[2], all of which have significantly higher CET1 ratios[3] set by global and local regulators than what smaller specialist banks such as Silicon Valley Bank (SVB) have to honour.
- The other significant feature is their access to liquidity should circumstances require.
- It may well be that future net interest income and margins will be lower than previously assumed, due mainly to the lower interest rate profile as priced in by money markets[4] at the time of writing. This will be negative for bank equity holders as the return-on-equity will be commensurately lower, but the strength of the balance sheets of banks in which we have invested our clients' money remains strong.
- Our exposure to bank debt has of course been raised recently through increased allocation to senior paper[5]. This is pretty much near the top tier of the capital stack, and it is likely the interim reaction to the SVB news will be some modest spread widening.
- The exposure to Additional Tier 1 (AT1) debt[6] will continue to be part of our long-term bedrock strategy.

RESPONSE FROM THE AUTHORITIES

- Over the weekend two significant announcements were made to not only help the beleaguered SVB but also to try to establish a back-stop to allay fears of depositors pulling money from other small/medium sized banks.
- The first is the Federal Deposit Insurance Corporation (FDIC) effectively insuring those depositors who fell outside the insurance scheme, and this will not involve tax-payers bailing the banking system out, but the banking system itself providing the back-stop; ultimately it will mean more insurance premium contributions to be made by the larger banks going forward.

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1 A globally systemically important bank (G-SIB) is a bank whose failure might trigger a financial crisis; every year the global banking regulator updates this list and currently lists 30 institutions of varying degrees of importance. They have been colloquially referred to as "too big to fail".
2 National champions are corporations which are not listed as a G-SIB but command a dominant position in a domestic economy. Examples in the UK are Lloyds Bank and Nationwide Building Society.
3 Common Equity Tier 1 (CET1) is a component of a bank's capital that is made up of common stock and accumulated earnings.
4 The money market is a component of the economy that provides short-term funds. The interest rates vary depending on the maturity of loan, and we can extract the implied interest rate at certain points in time from these rates.
5 In the event of a company's bankruptcy or liquidation, a senior security is one that ranks very high in the order of repayment before other security holders receive a payout.
6 These are "junior" bonds issued by banks that contribute to minimum levels of capital they are required to hold by regulators.

- The other announcement was by the Federal Reserve (The Fed), introducing the Bank Term Funding Programme, which will allow banks to borrow funds from the Fed if faced with large deposit withdrawals that may have required realising losses when selling bonds. In turn, the banks will need to lodge the (loss-making) US Treasuries at the Fed as collateral to this loan. This facility will now allow SVB customers to withdraw funds from today without more realised losses needing to be crystalised.
- SVB also has a UK operation, which is independent of its US parent's business: it was announced on 13th March that HSBC would buy this bank. As with the US parent bank, the UK operation also focussed on tech companies as customers, and it came as a huge relief a bank the size of HSBC had taken the bank over.

MARKET RESPONSE

- There has been a sharp fall in US Treasury bond yields (USTs), led by the short end of the yield curve as investors opted for safety and quality. The 2-year UST yield is now a full 1% lower than the recent peak, currently standing at 4.1%. Other major bond markets have seen similar moves. The timing of the flight to quality clearly signals the market is currently more concerned with the potential disinflationary impact of the SVB collapse, than the prospect of CPI (Consumer Price Index) measures getting out of control on the upside. As such, money markets are no longer pricing in rate hikes this year and have re-priced up to 3 quarter-point rate cuts by end-2023.
- Credit spreads have widened somewhat over the past week, as higher beta asset classes respond to the recent events. Much of the focus is those issued by the small/medium sized US banks, and to a lesser extent European banks. The more junior debtsuch as AT1 has been marked down by more, primarily due to cautionary reasons than anything more fundamental.