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OUT OF THE ORDINARY

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SVB – Silicon Valley Bust

John Wyn-Evans
Head of Investment Strategy

There's an old saying that if you see a queue forming outside a bank you should join it. The reason for this is that it is probably a queue of people waiting to take their money out and you should get yours out too before there is none left. Such scenes have played out in films including It's a Wonderful Life and even Mary Poppins. One doesn't have to reach back far into the memory banks to recall the demise of Northern Rock in 2007. A "run on the bank" can turn into the stuff of legend, and with remarkable speed.

This is effectively what happened to Silicon Valley Bank (SVB) in the United States last week, although the queues didn't materialise, because requests to repay deposits these days tend to be made online. But when customers tried to remove $42bn of their funds on Thursday (out of a total close to $200bn), the writing was on the wall. The nature of fractional reserve banking is such that no bank would have such a proportionately high amount of cash to hand.

Although SVB was the 16th largest bank in the US, as measured by the size of its balance sheet, it was not a household name until last week. The biggest question to be answered is whether SVB's travails are isolated or whether there is a wider risk to the banking system. As is often the case, there is no clear-cut answer, although we, and the market in general, would lean towards the former conclusion. Even so, investors are taking a safety-first approach initially.

What happened at SVB?

How did SVB get into this mess? In a sentence, it was caught between the jaws of a squeeze on its deposits and the value of its investments. A bank's health is often predicated upon the balance between its assets (loans and investments) and its liabilities (generally customer deposits, but it can be short-term funds borrowed from markets, as was the case at Northern Rock, for example). SVB had grown at break-neck speed, marketing itself as the go-to bank for high-growth technology companies. Many of those companies had been recipients of investment funds from venture capitalists (VCs) and other investors and they needed to put those funds on deposit somewhere before drawing them down in the normal course of running their businesses.

Given the location of its headquarters and its close ties with the technology industry in Silicon Valley, SVB was a natural destination for the cash, and, as often is the case, the bigger it became, the more cash it attracted. Its deposits tripled in the space of three years. Then it had to do something with all that cash. Cash deposits are generally converted into some form of loan or into an asset that fulfils regulatory capital requirements (such as a government bond). In the case of SVB there was not a huge demand for loans (because the technology companies were funded by VCs) and so they invested more than half of the available cash into securities.

So far, nothing too untoward. However, a lot of the investments were not in near-cash equivalents, such as short-dated government bonds, but in ones with longer maturities, where they could pick up a higher yield. They might have got away with this had yields not shot up in 2022, thus creating a capital loss on those investments. They might still have survived had their deposit base not started to shrink. Those technology companies were slowly but surely drawing down their deposits to develop their businesses and pay their rent and wages. And this at a time when VCs were not being quite as generous with new funds owing to the rapid decline in value of such companies. The VCs started demanding profits rather than showering cash. In the end, it came to the point where SVB had no option but to liquidate some of its investments at a loss to fulfil demands for cash from customers. That was when the dam broke.

What is the scale of its losses?

In selling $21bn of investments, it incurred a loss of $1.85bn which it could no longer hide behind arcane accounting conventions. This smashed a big hole in its regulatory capital base, which it tried to fill with an equity and preferred stock issuance. But the cat was out of the bag, and it was overwhelmed by clients wanting to take out more cash than it could get its hands on before the fundraising was even off the ground.

The speed of the demise is not unusual in such cases, but it is salutary that just days previously SVB had been a nominee in a Bank of The Year awards ceremony. Not for the first time, we are reminded of a conversation between two characters in the Ernest Hemingway novel The Sun Also Rises: "How did you go

bankrupt?" "Two ways. Gradually, then suddenly". SVB's share price peaked in November 2021 at $755, before last trading at $106. Even as recently as 2 February this year it was $333. Now it is worth nothing, and regulators have made it very clear that equity holders will be wiped out.

The act of declaring SVB bankrupt by federal authorities in the US was itself historic. It occurred during market trading hours on Friday, which is, as far as I can tell, unprecedented. These things usually happen overnight or at weekends. No doubt it was an attempt to draw a line under the situation, but it only ended up making things worse. Another feature of SVB's deposit base was that the average deposit was, reportedly, around $5 million, well above the $250,000 cap on insured deposits. Indeed, around 95% of the deposits were uninsured. Now, this didn't mean that they were worthless. The bank would have been wound up and depositors made whole (or at least largely whole according to research we have seen). However, they would not have had access to these funds for months, or even years, and so would effectively have run out of cash to run their businesses, leading potentially to further bankruptcies, which would, in turn have led to job losses, failed rental payments and so on. Certainly, the recipe for a nasty economic downturn.

How have the authorities intervened?

We have always maintained that the experience of the financial crisis in 2008 left such deep scars that the authorities (either the central bank or the government) would not allow liquidity to dry up again, especially where it was being denied to businesses that were otherwise perfectly solvent. And so, on Sunday a new announcement was made guaranteeing all deposits at SVB as well as introducing a new facility called the Bank Term Funding Programme. The BTFP allows a bank to borrow money from the Federal Reserve for a year against the value of its investments, meaning that no bank should be forced into a fire sale of assets at a loss which would undermine its capital base.

There was also good news for depositors at the UK arm of SVB. Again, the authorities moved quickly to avert a deeper crisis developing, and HSBC has bought the business.

This is all good news in that it averts a possible liquidity crisis, but huge questions remain. It seems that what one could infer from all of this is that the Fed has finally broken something with its tighter monetary policy and that this signals that it is time to "pivot" to looser policy – or at least to reduce the terminal rate expectation. Indeed, rate expectations have fallen dramatically since the middle of last week. But you can't have your cake and eat it. If the general consensus is that SVB is an idiosyncratic outlier and not creating systemic risk (which was very much the opinion doing the rounds at the end of last week and through the weekend), then did the Fed break it or did it, in fact, break itself through a combination of over-confidence, lax risk controls, misguided balance sheet management and sheer incompetence? The Fed has not opined specifically on this yet, and I think we will have to wait and see.

Is this likely to impact others?

It is also clear that banks are facing pressure on net income margins from a demand for higher deposit rates. Deposits are leaving banks in search of higher returns, and this is clearly seen in the fact that the total amount parked in US money market funds has reached an all-time high of $4.9 trillion. We can also see it in the demand for short-dated government bonds. The banks will have little option other than to pay up. But we do not see the same mismatched duration risks in terms of bank balance sheets in the UK and Europe, nor within the "too big to fail" banks in the US.

We think the initial conclusion is that we have dodged a bullet here, but that this is unlikely to be the last impact of the tighter monetary policy cycle. We are still working through the effects of the biggest one-year increase in US interest rates in history, and from an unusually low base which many thought

would be persistent. It just takes time for the effects to reveal themselves, and not always where one might have expected – for example, LDI in the UK and what that did to the Gilts market and the pound. Yes, it was the Truss/Kwarteng budget that was the catalyst for the sell-off, but the conditions for it had been created by the preceding relentless rise in yields.

It still doesn't feel like the time to abandon our cautious approach to risk. But neither is it time to hit the panic button. We are feeling our way through the most difficult part of the economic and financial market cycles. There have already been several false dawns, but there will eventually be a real one. We remain of the opinion that another financial crisis is not in the offing, but we continue to believe that slowing economic activity has yet to be fully reflected in aggregate company earnings.

Economic Commentary

FTSE 100 weekly winners

Melrose Industries PLC	5.1%
Informa Plc	2.8%
BT Group plc	2.4%
BAE Systems plc	2.4%
National Grid plc	1.8%
United Utilities Group PLC	1.5%
B&M European Value Retail SA	1.3%

FTSE 100 weekly losers

Ocado Group PLC	-18.0%
Admiral Group plc	-10.9%
Glencore plc	-9.6%
Polymetal International Plc	-8.3%
Rio Tinto plc	-8.3%
Barclays PLC	-8.2%
British Land Company PLC	-7.7%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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