14th March 2023

Elston Insights

US Regional Banking Crisis

- SVB collapse triggers memories of the 2008 financial crisis
- US Fed and government acts to restore faith in the banking system
- Markets remain volatile but no indications of contagion

Key messages

1. US regional bank SVB's failure is a result of poor management and a casualty of yield volatility amidst the prospect for higher-for-longer rates.

2. We do not think it creates risk of global contagion, but indirectly tightens financial conditions allowing Fed to become more accommodative.

3. This event is a reminder of the importance of having a well-diversified portfolio.

What happened?

On Friday 10th March, Silicon Valley Bank (SVB) and on Sunday 12th March Signature Bank, (both are US regional banks) were declared insolvent. SVB was not only the first bank to fail since the COVID crisis of 2020 but also one of the biggest since the financial crisis of 2008.

The FDIC (Federal Deposit Insurance Corporation) immediately seized control of SVB assets valued at US$175.4 billion and managed to keep the bank open for business on Monday. In the US, bank deposits up to US$250,000 are protected (similar to UK FSCS). However SVB was the bank of choice for Tech sector start-ups in Silicon Valley and over 85% of accounts at SVB were above the US$250,000 limit, leaving most deposits mainly uninsured.

This created a panic among depositors that they would not get their money back. The trust in the banking system was at stake over the weekend. Recognizing the urgency of the situation, the US Federal Reserve (the Fed) and the US government announced that all deposits at SVB and Signature bank would be protected, so depositors will have full access to their money, restoring much-needed faith in the system.

Drawing on its experience from 2008, when markets seized after a crisis in confidence, the Fed has also created a new facility called Bank Term Funding Program (BTFP), which would offer loans up to 1 year to qualifying institutions to prevent any further damage to the system. This creates a backstop and mitigates the risk of contagion (a key watch word from the previous financial crisis) preventing this crisis from broadening within the US or globally.

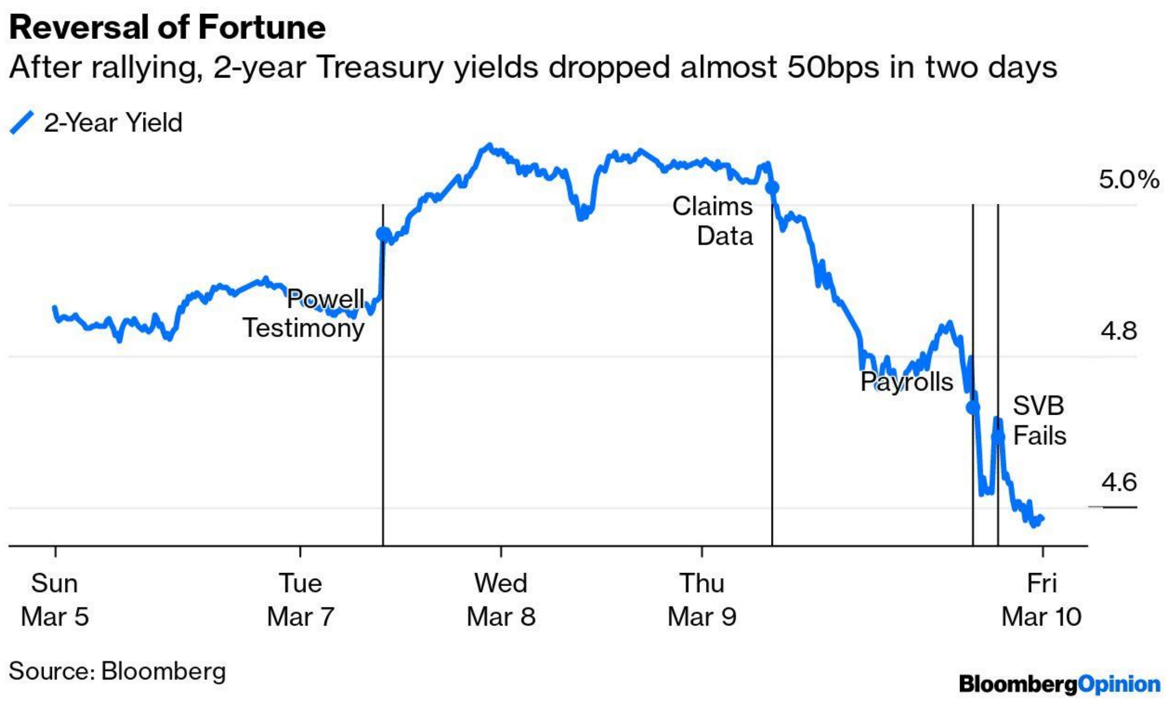
Why did it happen?

SVB was a preferred bank for Tech start-ups in Silicon Valley and attracted huge amounts of deposits from successful corporates during 2021. Like all other banks, SVB kept a small amount of cash on hand but used the remaining deposits to lend money to other companies and invest in safe assets such as US government bonds. This is typically how all banks function (they borrow short-dated and invest long-dated and earn the net interest margin in between).

In 2022, with the Fed raising interest rates at a record pace to fight inflation, bond yields rose dramatically, while bond values plummeted. Whilst some hoped that this trend might reverse, the Fed's comment last week that rates could stay higher for longer sent 2-year treasury yields spiking to 5% causing pain on those who had bet against this, or had unhedged long-dated bond positions.

Yields then began to decline on Friday 10th March with non-farm payroll claims data, which suggested unemployment was paving the way for potential future rate cuts. As the SVB bank run developed, investors then flocked to safety (selling risk asset and buying safe US treasury assets) which drove 2 year bonds yields sharply down.

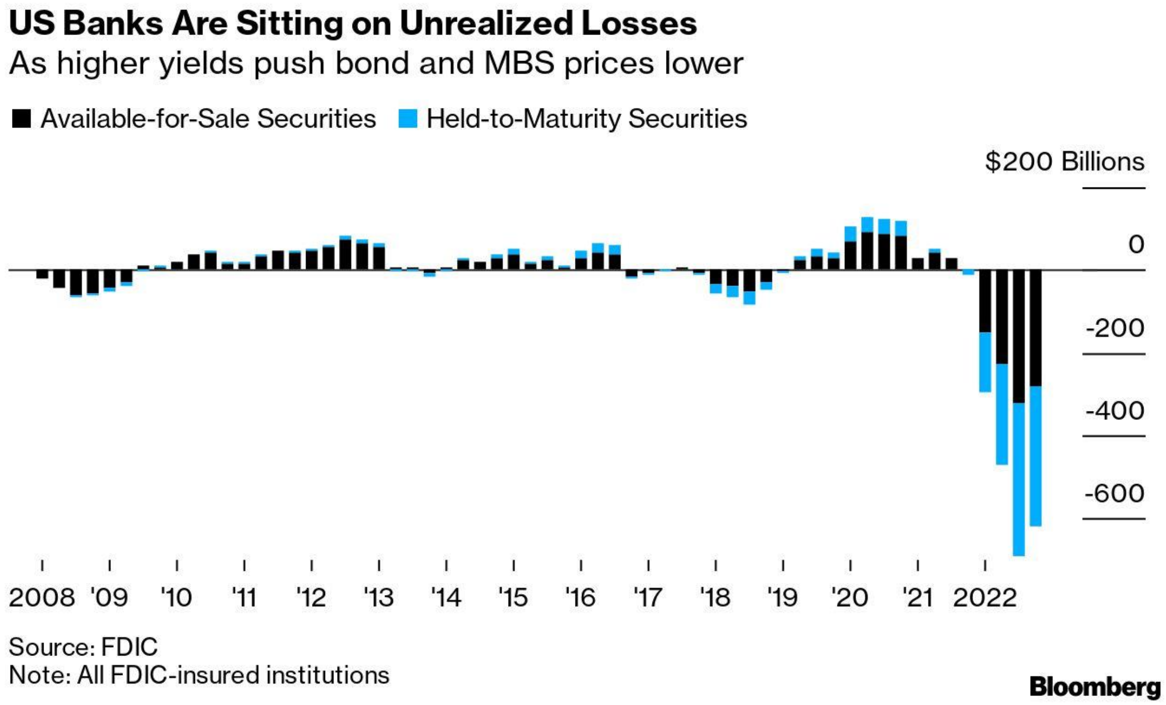
The one week rollercoaster of the 2 year US treasury yield is illustrated in the chart below.



Why does this matter for banks?

It is common practice for banks to hedge any such interest rate risk on their investments, but SVB was unusual (and irresponsible) as it did not hedge this interest rate risk. This created a large unrealised loss on its bond holdings (primarily US government bonds)

Ironically SVB's Chief Administrative Officer, Joseph Gentile, worked as Chief Financial Officer at Lehman Brothers' Global Investment Bank. Gentile left Lehman in 2007, just one year before it went bankrupt in 2008.



Furthermore, the rapid spike in bond yields meant that unrealised/uncrystallised losses has mushroomed. This forces US banks to rein in their activities, thereby tightening financial conditions. However, we expect the Fed to keep fighting inflation with rates policy whilst intervening where necessary to contain contagion.

As the bank needed to maintain a minimum asset base, SVB announced plans to raise additional capital by issuing more stock and bonds, but this failed to attract investors, creating panic-selling in its shares. SVB shares collapsed more than 60% on Thursday March 9th and are now worthless (hence the importance of a portfolio having low security-specific risk).

The killer blow was when depositors realised they might not be able to get their money back, this triggered a classic "Bank Run", as they all rushed to get their money out at the same time. SVB bank reserves were not sufficient to cover all withdrawals and ended up being insolvent on Friday 10th March.

Is this another Global Financial Crisis?

It's been a crisis for SVB and as a result all US regional banks share prices have been marked down. But we don't think there is risk of global contagion. There are separate concerns around Credit Suisse's financial position in Europe which may result in a forced merger, but that is entirely unrelated. SVB's collapse was not due to a credit quality issue: the assets that SVB held (US Treasury bonds) are one of the safest from a credit worthiness perspective. This is a classic case of a bank run on a poorly managed bank. Bank runs happen when depositors lose trust in the banking system and may result in large scale withdrawals, but with the new BTFP program, further insolvencies should be prevented.

Bank failures in fact are much common than most people think. Since 2009 there have been 513 bank failures in the US and the banking system is very well equipped with dealing with failures of poorly managed banks.

What is true is that the relaxing of the stringent post financial crisis rules and controls for US regional banks has left them more exposed to poor management. This is why US regional bank shares declined so dramatically.

Bank failures since 2009

Year	Total number of bank failures: 513
2023	2
2022	0
2021	0
2020	4
2019	4
2018	0
2017	8
2016	5
2015	8
2014	18
2013	24
2012	51
2011	92
2010	157
2009	140

Source: Federal Deposit Insurance Corp.

What happens next?

In light of recent events, bond yields have collapsed and broad equity markets in the US and Europe have sold off but the pain has primarily been in US regional banking stocks.

Market conditions remain uncertain, but we believe that since the Fed has put a backstop in place, this would not result in a further contagion. The large US banks would tend to benefit as depositors flock to them. Large banks have a much stronger balance sheet compared to that in 2008 so the chances of another Global Financial Crisis are reduced.

Looking ahead, the market is now pricing in Fed rate cuts instead of rate hikes. Ironically, this mini-banking crisis in regional banks acts as a form of financial conditions tightening that the Fed was trying to bring about through its "higher for longer" policy. Once the dust settles, we believe the Fed will continue to focus its efforts on reining in inflation once financial stability concerns have subsided.

How are we positioned?

In our monthly outlook dated 1 March 2023, we downgraded US equities on valuation concerns and remain underweight on European equities as they are priced to perfection. We also started to go overweight longer dated US treasury bonds on increased risks of a recession, but did not anticipate a crisis unfolding so suddenly. Our preference for treasury bonds over corporate bonds was because corporate bond spreads had narrowed substantially and could potentially rise on any adverse shock even without a change of interest rates. This prudence has helped now that spreads have widened as a result of this shock.

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