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Banking is very good business if you don't do anything dumb

- Warren Buffet

SVB - second largest bank failure in US history after GFC

After the collapse of US Investment Bank Lehman Brothers in the year 2008, regulation and supervision of the financial sector has been strengthened considerably. Banks have thicker and better capital cushions to absorb losses, and they are now better able to convert assets into cash in times of stress. Countries also use stress tests to check the health of the biggest banks and have set up oversight authorities to monitor risks to the financial system. With all these regulation and supervision, none of the financial experts would probably imagine the collapse of another US bank. In March 2023, we had the collapse of not one, but two US regional banks – Silicon Valley Bank and Signature Bank.

Traditional bank run resulting from ALM?

Most would argue that the collapse of SVB is a typical textbook case of asset liability mismanagement, exacerbated by quantitative tightening and steep rising interest rate in current inflationary environment. In the case of SVB, their business model catered to venture capitalists and technology startups. As these were corporate deposits, they were often larger than the Federal Deposit Insurance Corp.'s USD 250k insurance limit. SVB had over USD 150 billion in uninsured deposits as of the end of last year. In March 2023, SVB announced it had sold off a significant number of securities at a loss and was planning to raise USD 2.25 billion through selling new shares in order to shore up its balance sheet. This triggered mass panic among prominent venture capital firms, leading to a run on the bank. In the case of Signature Bank, the bank run was a contagion effect from SVB. Like SVB, Signature had a relatively large amount of uninsured deposits because of its business model catering to private companies. In addition, the bank was one of the largest serving cryptocurrency firms.

Regulators and the FED have been swift in their response to contain the market panic. Federal Deposit Insurance Corporation announced full protection for both insured and uninsured depositors but only for the depositors of SVB and Signature Bank, while the Fed has introduced a new lending facility, the Bank Term Funding Program (BTFP). This lending facility is designed to avoid banks that are facing deposit outflows from being forced to sell their bond holdings at a loss. This is achieved by the Fed accepting eligible collateral at par, which at the same time maximizes the capacity of banks to borrow from this lending facility. Fed officials have reportedly commented that the BTFP is big enough to cover all uninsured deposits in the US. Of the close to USD 18 trillion of domestic deposits, around USD 7 trillion are uninsured. It is worth noting that there is no limit on the amount an individual bank can obtain, which implies that any individual depository institution may borrow up to the par value of eligible collateral.

Contagion Effect

The collapse of SVB and the official response has also seen an intense focus on unrealized losses of US banks on their bond holdings. And, more broadly, it has also raised questions about unrealized losses on European banks' bond holdings. The widely cited FDIC data on US banks' unrealized losses on their holdings of bonds in Available-for-Sale (AfS) and Held-to-Maturity (HtM) portfolios certainly point to significant unrealized losses. As Figure 1 shows, total unrealized losses stood at around $620bn in 4Q22, with $280bn in AfS and $340bn in HtM portfolios. For Euro area banks, Figure 2 shows the cumulative revaluation adjustments on a quarterly basis over the same period and suggest that the cumulative losses on both AfS and HtM portfolios were around €115bn in 4Q22. Euro area banks' duration exposures have been relatively steady since 2020 and if anything declined since late 2021, while US banks' duration exposures have increased sharply since the pandemic. This difference in scale of unrealized losses shows European banks are in a much better shape to deal with rising interest rates.

Figure 1 - FDIC-insured institutions' unrealised gains (losses) on investment securities

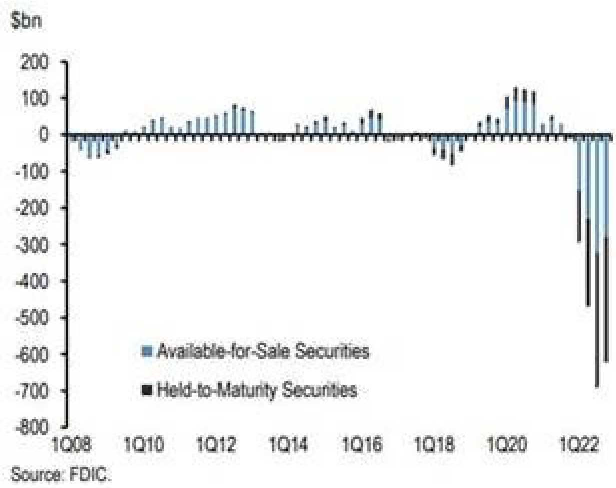
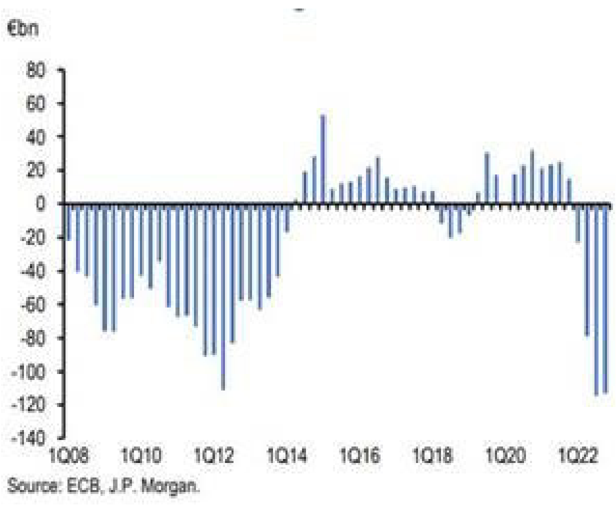


Figure 2 - Cumulative revaluation adjustments on Euro area banks' debt securities holdings



Regardless, with fear of contagion spreading, European banks have also come under pressure, forcing regulators to step in and shore up unsteady financial institutions. In the same month, Swiss banking giant UBS agreed to acquire its long-time rival Credit Suisse for more than USD 3 billion in a deal encouraged by regulators to help restore confidence in the global banking system. It was worth noting how fast Credit Suisse moved from a bank without a capital or asset quality problem to being taken over by UBS. This is an example of how vulnerable banks are and how fickle confidence can be. As a result, the equity versus debtholder outcome for Credit Suisse has left its AT1 investors with nothing. EU regulators have been swift to make their position clear – in the EU, equity is wiped out before debt goes.

Is there a broader financial crisis?

In general, overall health of the US banking system is still strong especially after the GFC in 2008. Large US banks have been subjected to more restrictive regulatory regime, which include higher capital and liquidity requirements, periodic stress testing and restrictions on the types of investments banks can employ in their bond portfolios. Banks with less than USD 250 billion in assets have been exempted from such regulations. As such, we would expect tighter regulation to be reinstated back on these small and mid-sized banks. Today's banking crisis was triggered by bad risk management practices around deposit management and interest rates. Each of the failed banks focused on a risky, concentrated customer segment, quickly grew deposits, converted these funds into loans and bonds when interest rates were low, and assumed interest rates would not quickly rise. In addition, due to Dodd-Frank, all the banks have living wills in current times. This implies that federal government can take them over if necessary, and unwind them. However, that being said, time is still required for current turbulence to subside.

Recent data has shown that the financial stress that emerged following the collapse of 2 US regional banks may be stabilizing as well. US institutions had a combined USD 148.7 billion in outstanding borrowings in the week through April 5, compared with USD 152.6 billion the previous week. Emergency borrowing retreated for the third straight week, suggesting liquidity demand continues to ease following the second-largest bank failure in US history. Over the past few weeks, banks appear to have shifted a larger share of their borrowing out of the discount window, the Fed's traditional backstop lending program, and into the new emergency lending facility it launched last month to help stem contagion in the bank sector.

Implications of the banking turmoil

Recent events in the banking sector have raised concerns around the availability of credit to businesses and the knock-on implications for the real economy. Concerns are most acute around smaller banks, who will likely face more difficulty raising funds, and for the small businesses that rely on them. We see heightened risk that tightening in lending standards will accelerate on the back of recent developments, leading to slower loan growth, and wider loan spreads. According to the SBA, small businesses are those that employ fewer than 500 workers, and between 1995 and 2021, they accounted for nearly 63% of net new job creation. Today, nearly 47% of all private sector employees work at a small business, have an aggregate wage bill that amounts to nearly 40% of the total, and represent more than 43% of US GDP. The prospect of substantial tightening in credit conditions raises the risk that a soft-landing turn into a harder one. Smaller firms, which have been a key driver of labor market resilience in recent months, are particularly sensitive to tighter bank financing conditions. As a result, despite recent hot prints, job gains could slow quickly.

Following the above, market has been pricing in extensive rate cuts by the Fed. We have seen a bull steepening on US treasury yield curve. UST 2 years yield fell more than 100 bps, while UST 10 years yield fell 65 basis points. As such, growth companies were back in demand with Nasdaq entering into a bull market. The investment rationale is that large companies with strong balance sheets and the ability to fund their own growth should benefit from an environment in which it becomes tougher to access capital markets. Big technology and consumer tech companies from Apple to Amazon once again find themselves the center of attention, as interest rates move significantly lower.

SVB failure will increase industry competition for deposits. Competition should intensify 1) among banks, 2) between lower cost deposit categories and higher cost categories like CDs, and 3) with money market funds and Treasury Direct, both of which present an attractive alternative to investors looking for a low-risk avenue to deploy their liquidity. As a result, sticky, core, operating deposits will become more valuable for banks. We expect deposit betas to rise materially as banks seek to attract deposits. In addition, banks could see higher expenses as they enhance their product set and customer experience and see lower fees income as the Earnings Credit Rate (ECR) moves higher.