



Mutual Limited

## MUTUAL OBSERVATIONS: SILICON VALLEY BANK COLLAPSE – LEHMAN BROS 2.0?

March 2023

### Background...

- Late last week I observed and highlighted in my morning note (Friday – 10 March) the extreme decline in the share price of Silicon Valley Bank, or more accurately it's holding company, down some 60% in one day. Since my note the bank and parent has collapsed as a whiff of liquidity problems triggered an unsustainable run by some very chunky depositors. That's the very simple version of events. The situation has attracted a lot of attention as the bank in question, while not big in the grand scheme of things, the situation has fuelled concern that perhaps there are other banks with similar liquidity problems. And, yes another bank has found itself in a similar state. Is it a potential global contagion concern, and are Australian banks at risk? Short answer on the latter is no, and the long answer is definitely not.

### Details...

- I won't do a deep and forensic dive here on SVB, but I will touch on the big picture circumstances that created such a pickle and then opine on why it is nothing to worry about for Australian banks, or financial systems more broadly – although we are likely in for a few days of elevated volatility as the situation evolves. The following thoughts and comments were put together by yours truly, but much of the digging and analysis was done by the broader Mutual Limited investment team. A tip of the cap to the team for working over the long weekend.
- First, who is SVB and what do they do? *“Silicon Valley Bank (SVB) was a commercial bank headquartered in Santa Clara, California. SVB was the 16th-largest bank in the United States at the time of its failure on March 10, 2023, and was the largest bank by deposits in Silicon Valley. It was a subsidiary of the bank holding company SVB Financial Group. The bank operated from offices in 13 countries and regions.”* Lazy, but that's from Wikipedia.
- The bank was founded in 1983 and over the years specialised in the niche world of tech start-ups. A significant proportion of its deposits were from tech start-ups, i.e. IPO proceeds, which are used to fund growth phase of these business, so high cash burn until they succeed or fail. SVB was not by definition a traditional commercial bank. At the end it had US\$212bn in total assets, generated US\$6.2bn in net revenue, from which they netted \$1.5bn in income. They were well capitalised, with CET 1 of 12.09% and total capital ratio of 16.2%.
- Second, so what went wrong? It's the old fashion asset and liability mismatch trick, which ultimately led to a liquidity problem. It wasn't, and still isn't a solvency issue, or an asset quality concern. SVB didn't really lend to anyone. It had a shed load of deposits, but no lending to speak of. Rather than lend the depositor's cash out, like a normal commercial bank would, they

invested in a range of fixed rate securities, and here rests their downfall. Over the past year we have seen one of the most aggressive rate hike cycles in modern times. Consequently, fixed rate securities have been pummelled. Historic losses. And when depositors want their cash back, in scale, SVB had to sell these securities at deep losses...alarm bells rang.

- I've used the big crayon above to describe the situation, pretty much the way I described it to my 14-year-old son yesterday. So, let's sharpen the pencil a bit and look at it with a little more maturity and assumed more elevated intelligence. In doing this it should be increasingly obvious Australian banks are not exposed to the same risks fundamentally...not to say sentiment might be impacted by some nervous Nellies.
- Let's start with the left-hand side of the balance sheet, the assets. On the surface they were liquid. But as we dug deeper, we see a different picture. SVB's securities composition is mostly underwater with significant unrealized losses in their hold to maturity book (on an accounting level, these are not required to be mark-to-market them, so less impact to their capital). SVB's balance sheet while big at US\$212bn was not subject to standard regulatory liquidity and funding requirements, such as minimum LCR's (Liquidity Coverage Ratio) or NSFR's (Net Stable Funding Ratio). The threshold in the US for requiring such is US\$250bn, although it was previously US\$50bn, but was increased during Donald Trump's Presidency (to reduce compliance costs to smaller banks). Whoops!
- Without these regulatory requirements SVB were not obliged to lengthen or raise stable deposits nor hold more specific types of HQLA (High Quality Liquid Assets). Their 'liquidity' composition is, in a word, terrible. While most of their holdings were government guaranteed, only 14% are actually held in liquid US treasuries. The balance includes a mixed bag of securities issued by government or state-owned entities such as Freddie Mac, Fannie Mae, Federal Home Loan Bank System, Farmer loans, and Student Loans. While they're rock solid from a credit quality perspective, they're probably not the best securities to hold given SVB's business model, i.e. liquidity mismatch. To add more fuel to the fire, SVB undertook negligible hedging in their fixed income portfolio, with duration of around 5.6 years.
- So, assets are of good quality, but they were largely fixed rate, and unhedged, so heavily under water. What's the liabilities (deposits and borrowing) look like? Firstly, their borrowings are negligible. More than half of SVB's deposit base were non-interest bearing so we're assuming they're mostly demand deposits. The big red flag was ~87% of their deposits are NOT FDIC (Federal Deposit Insurance Corporation) insured suggesting most of their deposits were institutional with minimal retail presence.

### ***The nail in the coffin...***

- SVB experienced continuous institutional deposit withdrawals funded by repo'ing a significant part of their liquids book (lending securities for cash). When they couldn't repo anymore without drawing attention, SVB borrowed another US\$15bn from the Federal Home Loan bank of San Francisco (a chartered bank that provides cheap funding to other banks).
- As the deposit run-off intensified, they were forced sellers of their trading book crystallising significant losses, which is where it all went wrong. The hold to maturity book was not hedged in a rising interest rate environment and if they wanted to monetise their hold to maturity book they would have to move the assets to AFS or 'Available for Sale' accounting treatment (mark to market) which would immediately smash their capital.
- So, in the end, a massive imbalance with 'at-call' hot institutional money dumped into long dated less liquid fixed income securities with the majority placed in the hold to maturity book. And the Fed is hiking rates like it's the fashionable thing to do.

### ***Market reaction...***

- A lot has happened over the weekend, so US market's reaction from Friday is largely stale. Nevertheless, we saw a slump in treasuries yields, -20 to -25 bps on a flight to quality trade on Friday night. Then last night, that slide continued with more vigour. US bank share prices have come under selling pressure particularly smaller regional based banks. The main issue is what does it do, if anything, to the Fed's hiking plans? My gut feel is nothing, after digesting all the regulatory reactions over the weekend is SVB will prove to be a relatively isolated incident, with the Fed to look through the noise and carry on hiking subject to the data. Having said that, a pause at the next meeting can't be ruled out, perhaps until the SVB situation is resolved. The pause narrative has gained support, so it could be on the cards.
- So, what's happened over the weekend? It would seem various regulatory bodies will step in to protect depositors – in one shape or the other – in order to prevent a run on other similar banks. There will be no bail out of equity and bond holders, they're largely toast. These announcements seem to have calmed market nerves for now. Locally, we saw ACGB's open around -20 bps lower yesterday, but as they day as unfolded, some of these gains have been handed back, around half at this stage. Again, this morning yields have plunged with 3Y ACGB's down -22 bps to be just under 3.00% (3.60% at 28 February).
- Major bank spreads have drifted a smidge wider, around +5 bps across the curve since the situation came to light, yet trading has been muted. Tier 2 has been moved out more, but that is par for course, +10 - 15 bps on average. Again, no volumes of note traded at the time of writing. The ASX 200 is down a touch, but nothing eye watering. While there is uncertainty, spreads will drift wider, but it will be on muted flows.

### ***Are Australian banks at risk of a similar liquidity problem?***

- While risk of a run can't be completely discounted, the probability of a run being triggered by similar events to those that transpired with SVB is infinitesimally small. Why? Basically, it comes down to balance sheet structure, and regulatory oversight. On the former, Australian banks take in deposits from many, many sources. They then on-lend that money to borrowers and make profits. A somewhat simplified explanation, but accurate enough. SVB didn't do these things, particularly the lending part.
- Australian banks do not have significant amounts of deposits sitting in illiquid securities, which is what SVB did. The primary asset of Australian banks is mortgages, the vast majority of which are variable rate, so minimal interest rates. Further, Australian banks are encouraged by the regulator to hedge any interest rate risk they do have, i.e. they incur a capital charge if they don't. SVB wasn't and didn't. For the Major Banks, if not done so this attracts a capital penalty in the form of IRRBB (interest rate risk in the banking book) capital. Australia is the only country that does this.
- Australian depositors are highly fragmented and sticky. SVB's depositors were chunky and concentrated.
- And lastly, Australian banks are tightly regulated by APRA, whereas in the US the regulatory regime, especially for smaller banks is much looser. The deposit insurance schemes are different also. In the US it's pre-funded, whereas the Australian program is post-funded. If a bank in Australia goes under, a levy is imposed on the sector to cover any shortfall in deposits that are greater than the \$250K guarantee.