



Insigneo Weekly Dispatch

# The Silicon Valley Bank Collapse and its Implications on the Financial System

What happened with Silicon Valley Bank, the risk of contagion throughout the financial system, and implications for the Federal Reserve.

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## The Silicon Valley Bank Collapse and its implications on the Financial System

A lot can happen in a week. Last Thursday, the debate in the market revolved around whether the Federal Reserve was going to raise interest rates by 25 or 50-basis points in its meeting next week, with probabilities of a 50-basis point increase standing near 80%. Since then, we have seen the second and third largest bank collapses in the country in recent history, as well as a debate that now revolves around whether the Fed will raise rates by 25 basis points or not raise them at all, with some even suggesting a rate cut. And it's only Wednesday...

As we know, Silicon Valley Bank (SIVB) collapsed on Friday, and went under the purview of the Federal Deposit Insurance Corporation (FDIC). Signature Bank (SBNY) collapsed Sunday night. The FDIC, along with the Department of the Treasury, then stepped in to instill confidence in the banking system and protect depositors. The FDIC insures deposits up to \$250,000 per account. However, because a large number of SVB's depositors were startups and venture capital companies, deposit balances tended to be higher than the insured amount. It is estimated that as much as 87% of the bank's deposits fell outside the FDIC guaranteed amount, leaving them uninsured. After the collapse, regulators intervened by guaranteeing all deposits, regardless of amount.

The main objective of this move was not to bail out investors or creditors, but to protect the bank's depositors, so as to avoid panic and a potential run on other banks. Protecting the stability of the country's financial system remains paramount.

So, what happened with Silicon Valley Bank in the first place that got us to this point? **In essence, the bank failed to properly manage the risk on its balance sheet.** Through proper risk management practices, generally known as Asset-Liability Management, banks tend to ensure that the assets on their balance sheets match their liabilities. Assets are mostly comprised of client deposits and investments, whereas liabilities are mostly composed of loans. Banks take deposits and invest them or loan them out, therefore generating income. SVB's client base was heavily concentrated in the tech and biotech start up and venture capital companies. These companies tend to use intensive levels of cash. Back in 2021, SVB took billions in large deposits from these companies, as it was known to be the premier bank for this industry. Let's remember that, at the time, interest rates were at historically low levels. Not believing that the Fed was going to raise rates anytime soon, the bank invested a large portion of its deposits (its liabilities) in long-duration investment products (its assets).

To give you a sense of the scale of this position, most US banks invest approximately 20 to 30% of their deposits in duration-sensitive products. Silicon Valley Bank had invested approximately 60% of its deposit base, doubling that of most of its peers. Long-duration products are highly sensitive to interest rate movements, meaningfully rising in value as rates go down, and conversely, losing

significant value as rates go up. Fast-forward to 2023, after interest rates aggressively moved higher, and the bank was now sitting on meaningful losses in its duration-sensitive investment portfolio. In an environment of higher interest rates, cash-strapped startup and venture capital companies also experience increased funding costs, which induced the bank's depositors to attempt to access their funds. Faced with the perfect storm of increased demand for deposit redemptions coupled with \$1.8 billion in losses in its asset portfolio, management announced a proposed share issuance of approximately \$2.25 billion to cover the gap. This had the opposite and unintended consequence of creating panic, leading depositors to pull their assets in masse, and collapsing the bank due to a lack of cash.

The pressing issue stemming from this collapse is the possibility of contagion to other financial institutions. As we mentioned above, we saw Signature Bank collapse along with Silicon Valley Bank, and there is a probability that other, most likely small or regional banks with concentrated deposit bases or investment portfolios with heavy losses, could be affected by similar situations. Some regional banks, such as First Republic Bank, are beginning to receive negative credit watch designations by rating agencies. We have also seen extreme volatility in banking sector stocks over the past few days, particularly within the regional banks. Some of these have experienced moves of 50% or more in a single day, as investors question their financial prospects. Speculation is high, and it is easy to get sucked into this frenzy. This is why it is important to keep a cool head and look at the complete picture.

**As we said before, there is the probability that other regional banks may collapse; however, we do not believe that there is a high probability of contagion throughout the entire financial system, as there was in 2008.** Silicon Valley Bank had a

very concentrated depositor base, something that most banks do not have. Most financial institutions in the country, particularly those once deemed “too big to fail”, have large, diversified asset bases and are subject to more stringent regulations than in 2008. We are actually beginning to see a trend where deposits are leaving some regional banks and moving to larger and more established financial institutions. In fact, we would not be surprised if these larger banks absorb some of their weaker peers. Regulators have also stepped in and provided a liquidity back stop to Silicon Valley Bank’s consumer deposits, by directly insuring all of the bank’s deposits regardless of amount, as well as providing loans with favorable terms to other banks that might need assistance. Additionally, regulators are also considering the implementation of tougher rules for midsize banks.

Another important issue arising from the current situation revolves around the implications for the Federal Reserve and its resolve to control inflation. As we know, the Fed is looking to reduce inflation to more sustainable levels. However, given the choice between reducing inflation and preserving financial stability, we believe that the Fed would choose the latter. This does not mean that we think the Fed will start cutting rates in the very near future, as some in the market do. **We are of the position that a 25-basis point rate hike next week is the most likely scenario, with an outright pause not being out of the question.**

If we do see a pause, we believe that this would only be temporary in nature, as the Fed still has the mandate to control inflation. As we saw in yesterday’s CPI numbers, inflation, particularly core services inflation, is still present in the system.

Some on Wall Street are saying that what happened to SVB is a clear example of why the old “don’t fight the Fed” mantra rings true. Others are using this case to highlight the importance of adhering to proper risk controls. We agree with both views. Time will reveal the full impact of the fallout from Silicon Valley Bank’s collapse. Again, we do not see a 2008-type financial contagion taking hold. Regardless of how the situation unfolds, we will continue to monitor it closely, keep you abreast of new developments, and be here to address any questions and provide our views.



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