RBC Global Asset Management

INVESTOR INSIGHTS

The collapse of Silicon Valley Bank

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On Friday, March 10, it was announced that Silicon Valley Bank had been taken into receivership by the Federal Deposit Insurance Corporation ("FDIC") and its shares were halted with an implied price of zero. Only 36 hours prior, the company's shares were trading over $250. Understanding the situation is evolving rapidly, this article looks to explain the events leading up to Silicon Valley Bank's failure, and what it means for investors.

How did we get here?

When the U.S. Federal Reserve ("Fed") and other central banks increase interest rates like they have over the last year, they do so with the goal of slowing excess inflation. By raising interest rates, the Fed tightens financial conditions to suppress demand so that the economy, and in turn, inflation, slows.

These tighter financial conditions act with a lagged effect – from the moment the Fed starts raising interest rates, it takes time before the impact is fully felt in the economy. As an investor, you generally expect to see some negative impact on corporate profits. But when, where and how that will manifest itself within the broader economy is hard to predict.

Banks take in deposits and make loans and buy securities. The impact of rising rates has been most notable on security portfolios, particularly those with longer dated bonds, as rising interest rates suppress the value of bonds with the impact being larger the longer until that bond matures. A handful of regional U.S. banks have been pressured recently on the concern that, as they face deposit outflows, they may be forced to sell off some of their holdings at a loss in order to cover these outflows. Most notably, this concern was triggered by the failure of Silicon Valley Bank (SIVB) on March 10. It was taken into receivership as regulators worked to protect the interest of all depositors and stem disorderly withdrawals.

Why did Silicon Valley Bank fail?

SIVB didn't make too many loans against the deposits it held, as can often be the case with a bank failure. Rather, the bank invested most of its deposits in government bonds. Over the fullness of time, these bonds are "money-good"; they are backed by the U.S. government and will be repaid in full. But what's required to collect on the full promise of these bonds is to hold them to maturity. That means having enough deposits to finance ongoing transactions along the way.

As financial conditions tightened, many tech companies – SIVB's core clientele – needed to draw on their deposits to support their own operations. To fund these withdrawals, SIVB was ultimately forced to sell some of its government bond assets ahead of maturity, at a loss. As investors became increasingly concerned about SIVB's ability to fund these ongoing transactions, the rate of withdrawals accelerated beyond what the bank could facilitate. On March 10, The FDIC stepped in and put the bank into receivership to protect insured client deposits up to $250,000. The U.S. government later announced that all deposits, even above insured amounts, would be honoured.

Not all banks have the same regulatory scrutiny. Within the banking system, there are banks deemed by regulators to be systematically important financial institutions (G-SIFIs). These banks usually operate broadly across the globe, are most tightly regulated, and have access to a variety of deposit types from wholesale funding, client banking, business accounts, and more, making them very well-diversified. In the U.S., JPMorgan is an example of one such bank. In Canada, TD and

Royal Bank are deemed G-SIFIs. However, all of the big six Canadian banks are deemed domestically systematically important. These banks are all held to more rigorous regulatory standards.

Within the U.S., there are also a greater number of smaller regional banks. These regional banks may be more dependent on a small cohort of depositors than their G-SIFI counterparts. Silicon Valley Bank fell into this category, dealing mostly with early-stage tech businesses and similar start-ups.

How have markets responded?

In the short term, we expect to see continued volatility within equity markets as investors try to navigate three key questions:

- How exactly does this ripple through the financial sector?
- What impact might this have on the broader economy?
- Are stock prices adequately reflecting these risks?

The Federal Reserve's announcement that it will allow banks facing large withdrawals to borrow against their government securities at par should go a long way in helping restore confidence and prevent fire sales of these assets.

Beyond equity markets, bonds have rallied (yields have fallen) as investors choose to favour safe-haven assets. This flight to safety actually helps alleviate some of the mark-to-market risks for other regional banks as the prices of their holdings rise alongside the drop in rates and lower interest rates, generally speaking, are a positive.

The Fed will certainly take the health of the banking system into consideration and that will weigh on its upcoming policy decisions. It's possible that the discussions about how much higher rates need to go are accelerated in response to these recent events.

Should investors be worried about this spreading?

It's important to note that while headlines are quick to highlight that this is the largest bank failure since Washington Mutual in 2008, the events leading up to this are to some extent isolated to specific risks taken by SIVB. That said we believe it's very unlikely that this is the start of a chain of events like those seen during the financial crisis in 2008. At the onset of the crisis, bank leverage was much higher than it is today and investors were worried most about the quality of bank assets.

Today's environment is quite different, for the better. Firstly, there have been sweeping regulatory changes over the last decade focused on reinforcing the greater U.S. banking system. Beyond that, the quality of the banking sector's assets is not in question. Rather, in the current environment of rising interest rates, it has been the mark-to-market value of securities that has been impacted – the price at which banks can sell their bonds ahead of maturity.

Regulators have acted swiftly in their response to collapse of SIVB to signal they are going to support the banking system through this, and limit its spread. The Fed has acted quickly in setting up a new lending facility that will allow banks to access the full value of their government bond assets ahead of maturity, rather than taking a mark-to-market loss. This goes a long way towards taking care of depositors, and should give investors' confidence.

Some of this activity will assist the Federal Reserve in its initial goal outlined in the opening paragraph – to tamp down inflation. As inflation declines, central banks can then look at how long monetary policy should remain at these levels and even when it might become accommodative and the cycle will move to its next stage.

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