

# MARKET COMMENTARY

## What to make of the SVB crisis?

**GIAM Research**

March 13, 2023

- The crisis faced by Silicon Valley Bank (SVB), and Signature Bank, is a classical bank run – in the digital era.
- A large part of the risk seems idiosyncratic, as high duration assets and exposure to the technology sector made the banks particularly vulnerable to the sharp increase in rates.
- Yet with nearly 90% of affected bank deposits unprotected by the Federal Deposit Insurance Corporation (FDIC), the risk of contagion was still high, triggering the Fed and US Treasury to step in with a new generous liquidity support program and an extension of the protection to large depositors at all banks.
- This is a major step to contain the market rout and prevent it from spilling over to healthy institutions, while (again) raising moral hazard concerns for the future. Yet the crisis will create further headwinds to the US financial system, fanning the battle for bank deposits (in the context of intense competition from money market funds), leading to a greater concentration of deposits in the favour of large banks, and limiting the provision of credit to the wider economy. The systemic component of the crisis lies in the large amount of unrealised losses across financial institutions – not just banks – which creates an inherent fragility, especially in the case of suddenly rising liquidity needs.
- These events will further complicate the job of central banks, as they still seek to tame inflation. The joint tightening of financial conditions and lending standards does increase the recession risk. Barring a further escalation of the stress over the coming days, we still expect the Fed and ECB to envisage further rate hikes in March. A 50bp hike by the Fed appears highly unlikely, but we still deem a 25bp move more likely than a pause.
- The events add to the case for maintaining a prudent exposure to risk assets for now, while US Treasuries still have appeal as a good hedge against financial market stress.
- European banks also suffer from greater investor scrutiny, but overall appear better positioned than their US peers on various risk and valuation measures.

**Silicon Valley Bank (SVB) is an important financial institution for Tech start-ups.** The SVB crisis is a classic bank run, with many of the Tech clients burning cash too quickly, which implied a steep drop of deposits, and a deteriorating liquidity position at SVB. On 8 March the bank announced unexpected deposit withdrawals this year and the liquidation of the bulk of its Available for Sale (AFS) securities at a \$2bn loss. SVB thus needed a capital raise, which indeed accelerated its demise and led to the second largest US commercial bank failure in history. SVB's business has been very concentrated in the Venture Capital-backed Tech and life Sciences sector, which contributed to herd behaviours once the bad news started to make the round. Its deposits were heavily concentrated, with a far smaller base of retail business than the average regional bank, e.g. 95% were not covered by the

FDIC protection (limited to \$250k). Deposit outflows accelerated, while the stock price dived. The smaller **Signature Bank** – a leading lender for the start-up community and cryptocurrency industry – faced similar issues as SVB.

**The idiosyncratic nature of the crisis is significant.** SVB has had very poor risk and liquidity management, with a large duration gap between its liabilities and assets. The source of the crisis therefore is in the duration mismatch and the rise in yields, in contrast to the credit stress of the GFC. SVB was flooded with cash in 2021 as the private tech sector was booming and enjoying large venture capital investment. The \$100bn deposit base by end 2020 almost doubled, and the bank invested a lot of it in long-dated Treasuries and mortgage bonds, in the process creating the large maturity mismatch. Those bonds, largely in the held-to-maturity portfolio, saw their price decline aggressively through the historical bond drawdown of 2022. The portfolio lost some \$15bn in value, almost as much as the bank's entire capital. Those **large unrealised losses** became life-threatening when deposit outflows forced selling and losses were effectively being realised.

The post-GFC regulation was supposed to ensure better liquidity management, and many questions are being raised about the [failure of regulators](#) to **identify warnings signs**, e.g. SVB had become very reliant on the Federal Home Loan Bank of San Francisco for funding. This suggests that yet again rules have been eased excessively in recent years, for “small” lenders. And “small” needs to be qualified – as SVB was the 16th-largest US bank, with \$211bn in assets. Yet again **rating agencies were late** to the “game”, e.g. on 10 March Moody's slashed the credit rating on SVB's long-term local currency bank deposit to Caa2 from A1 and its issuer ratings to C from Baa1.

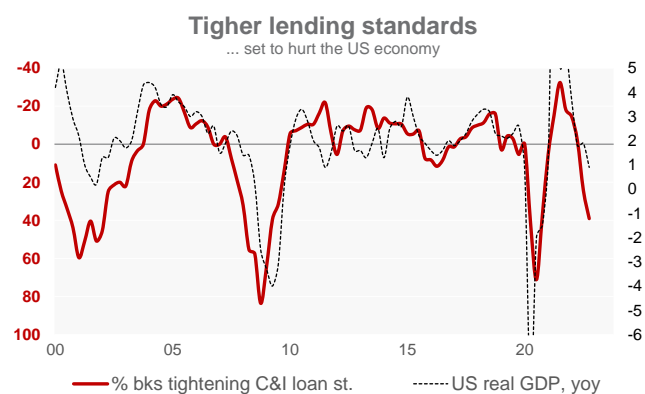
**The support plan.** US regulators stepped in very aggressively over the week to avert contagion. Depositors will be fully repaid. In normal circumstances, the Federal Deposit Insurance Corporation (FDIC) guarantees deposits of up to \$250,000. Yet this was of little help for SVB clients, where corporate deposits prevailed, leaving 88% of the deposits without FDIC protection. The Fed also announced a new lending facility aimed at providing extra funding to banks and ensure that they “have the ability to meet the needs of all their depositors”. The **Bank Term Funding Program (BTFP)** will offer loans of **up to one year** to lenders that pledge collateral including Treasuries, agency mortgage-backed securities and other “qualifying assets”, which will be **valued at par**. The Loans will be made with no prepayment penalty, at the cost of 1-year OIS +10bps. This is supposed to sharply reduced the pressure for banks to sell securities held to maturity (at a loss) in the case they face deposit outflows. The facility is backstopped by the Treasury, for up to \$25bn.

The Fed, Treasury Department and FDIC have thus acted in concert to avoid spill-over. They need to walk fine line of eschewing outright bailout (unacceptable given the post-GFC promises) and preventing a market run that could wipe out healthy institutions. The interventions announced so far suggest that US authorities are opting for a combination of providing onerous terms in public liquidity support while still keeping the FDIC (and ultimately US banks as contributors) in charge of any larger residual losses not born by equity and bond holders of failing institutions. Of course, such actions still raise moral hazard issues, though officials tried to reassure that no losses stemming from the resolution of failing institutions would be borne by the taxpayer (depositors are protected, not owners nor all unsecured debtholders). The solution also raises more tangible issues about potential losses for the Deposit Insurance Fund, and how they would be covered eventually. But financial authorities are likely right that the amount of unrealised losses in the financial industry is such that forceful action to immediately stop contagion was necessary – indeed the “systemic risk exception” was invoked.

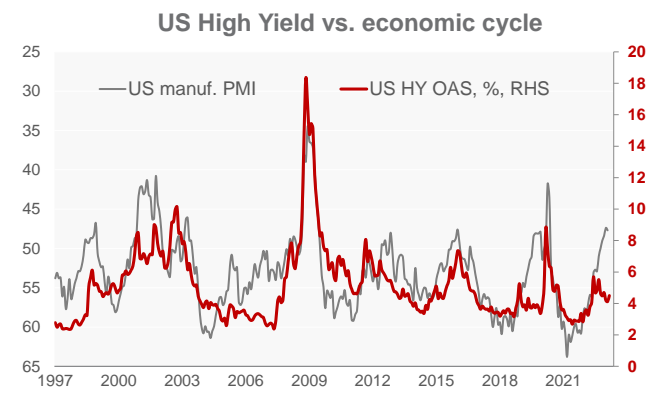
**Broader top-down and policy implications.** The crisis has a strong idiosyncratic component, and the banking sector today looks much healthier than prior to the GFC. Yet one cannot ignore a **fundamental fragility stemming from a year of extraordinary monetary policy tightening**. The Global Aggregate Bond index (in USD, unhedged) suffered a drawdown of 16.2% last year, a historical loss that has left many financial players with heavy unrealised losses on their books. This is manageable if the securities are held in portfolios that are not marked to market. But losses are realised when liquidity pressure leads to forced selling. The large amount of unrealised losses in the system creates an inherent fragility that tends to destroy the “animal spirit” by making all financial actors more defensive. This eventually feeds through the economy (see left chart below). Among the channels of distribution:

- **US banks will now compete more fiercely for deposits**, and more so that they face strong competition from money market funds. As a result, they may need to raise the rates they pay on deposits, at the risk of deteriorating profitability. They will also face **tougher regulation**.

- This deteriorating funding position will make the **banks more cautious and less eager to lend**. Already lending conditions have tightened, and this has been a key driver of our view that the US recession risk should not be dismissed too quickly ('no landing' talk grossly exaggerated).



Source: Fed, Bloomberg, GIAM



Source: ISM, Bloomberg, GIAM

- This episode reminds investors that a cycle of sharp monetary tightening always tends to create financial stability issues. This will also make investors more cautious, e.g. we had questioned the **sharp decoupling between High Yield spreads and the deteriorating economic environment** (right-hand chart below).

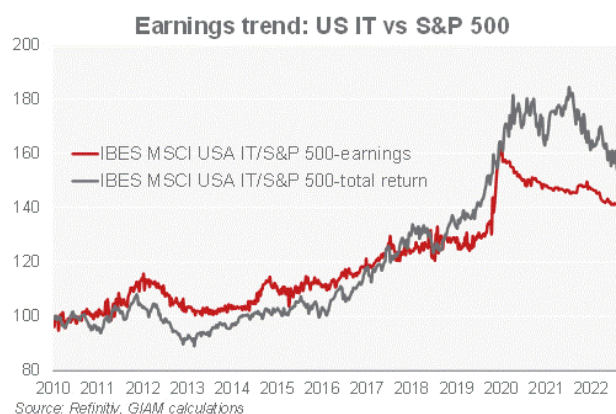
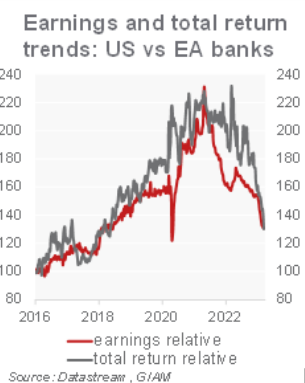
Such stress episode **will only make the job of central banks even more complex**, as they will be sandwiched between persisting inflation pressures and financial stability issues. Finding the right level of rates to stem inflation without excessively hurting growth is a learning process, and the sudden deterioration of financial conditions sends a **message that policy tightening is starting to bite**. In all, this will imply lower terminal rates than the markets had priced just before the crisis. The **market now sees the Fed peak at just 5.0% (upper bound, vs. currently 4.75%), which looks extreme** – the inflation pressures have not just disappeared. The next days will be decisive to assess the overall distress to the financial sector and the financial stability risk from further monetary tightening. This leaves some **clear downside risk to our base view** that the Fed will still need to raise rates by a cumulated 75bp to fully address the stubbornly strong price pressure.

The SVB and Signature cases also highlight the mounting cracks in the financial plumbing we have stressed for a while. Further vulnerabilities to the fast pace of global interest rates may show up in selected areas of the leveraged shadow banking sector. We also see stronger risks for companies exposed to the housing sector and commercial real estate.

These developments support our **prudent asset allocation stance** characterized by a cautious exposure to risk assets in general. Yields have already dropped sharply from their elevated levels amid safe haven flows and downgraded rates expectations for central banks. But notably exposure to US Treasuries still looks appealing, as a hedge against a more protracted risk-off mode on financial markets.

**Private markets exposed?** The repercussion of the SVB failure may have even more repercussion for private markets than public ones. It is estimated that nearly half of venture capital funds in the US had an account with SVB. Both investors and companies will now have to find other sources of funding, less venture capital friendly. This happens in a context of investors already running ahead of the crisis and withdrawing money from growth-oriented private capital funds. This has led companies to use more own funds and less external financing, which also weighed on deposits at SVB. It also led SVB to lend more to private equity funds as investors became more cautious. As private capital is highly exposed to the tech sector, portfolios are now more vulnerable. Hence the **rapid repricing of IG and HY tech spreads and share price of companies with private lending activities**. This will put the whole VC financing ecosystem under scrutiny.

This comes at a time of private markets having accumulated significant leverage and become more reliant on multiples expansion. Already before SVB's failure, the average deal value had contracted significantly, more so for venture capital than for buyouts. The possible downside for investors could materialise either through quick write-downs or via structurally lower returns over the medium term as the goodwill weighs negatively. The potential spill-over to public markets of tensions in private markets will come via the tech sector, including MedTech.



**EU Banks generally seem better positioned against the market stress than US peers.** We currently do not see a significant negative read across for European banks. European banks are better regulated, they are funded via retail deposits (which are stickier) and their liquidity & capital ratios are well above minimum requirements. Liquidity of European banks is adequately managed with LCR ratios amply above minimum requirement and LTD ratios generally around 100% – with national variations of course. Banks have strongly improved their liquidity management following the 2011 sovereign crisis; dependency on short-term instruments have been cut sharply and duration mismatches have been reduced. We acknowledge that banks have to repay the remaining TLTRO but they are prepared to this – most sensitive banks in this regard are Italian banks but we do not expect any systemic issue. The sharp rise in interest rates since early last year has surely driven down the market value of bond portfolios held by European banks. Yet we see European banks as being well placed to avoid the need to sell those bonds at a loss; in light of the stability of their deposit base, they can wait for a recovery in bond values (pull-to-par effect). The ECB has also shown its capacity to avoid system-wide liquidity issues; inflation now limits its firepower, but we expect increased scrutiny to further bolster system-wide resilience.

Turning to equity market fundamentals, EU Banks' prices have continued to lag earnings trend and they represent the 5<sup>th</sup> most undervalued EU sector in terms of our proprietary composite valuation rank (which includes market multiples). Furthermore, EU banks show better earnings momentum than US ones. That said, erosion in confidence, expectation of tighter regulation at the margin and a lower ECB terminal rate may cause headwinds in the short term. It will also take time to fully understand contagion risks.

**Finally, in the US Tech sector**, smaller firms will experience headwinds from tougher financing conditions by banks and venture capital funds. The big, listed names (US MSCI Tech sector) are not fully immune, if for different reasons. First, compared to the same sector in Europe, its relative earnings trend has lagged since 2021. The same seems true when looking the US Tech sector vs. the S&P 500 (see right chart above). US Tech also looks overvalued by nearly 20% vs the S&P 500 (based on PEG for example, i.e. the 12m forward PE adjusted for estimated earnings growth in the next 3-5 years). The S&P 500 index itself remains expensive vs. the MSCI Europe, by at least 10%. A weaker USD and lower yields will help but slower growth and a mild US recession in H2 would add to the negatives, postponing a possible rebound.

This document is based on information and opinions which Generali Insurance Asset Management S.p.A. Società di gestione del risparmio has obtained from sources within and outside of the Generali Group. While such information is believed to be reliable for the purposes used herein, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. The information, opinions estimates and forecasts expressed in this document are as of the date of this publication and represent only the judgment of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. It shall not be considered as an explicit or implicit recommendation of investment strategy or as investment advice. Before subscribing an offer of investment services, each potential client shall be given every document provided by the regulations in force from time to time, documents to be carefully read by the client before making any investment choice. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio may have taken or, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein provided. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible damages or losses related to the improper use of the information herein provided. It is recommended to look over the regulation, available on our website [www.generali-investments.com](http://www.generali-investments.com). Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro Italiane. Generali Investments is a commercial brand of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A..