CURRENT MARKET NEWS

Implications and Aftermath of the failure of Silicon Valley Bank

Yung-Yu Ma, Ph.D., Chief Investment Strategist, BMO Wealth Management - U.S.

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Background:

The rapid downfall of Silicon Valley Bank (SVB) set off a wave of uncertainty and fear in the markets. On Wednesday, March 8th, SVB announced that it would take losses on securities it was selling and also raise capital by selling common and preferred stock. At that time, SVB had a market capitalization of over $15 billion, and per the FDIC's December data had assets of over $200 billion and deposits of $175 billion. On Thursday, March 9th, over $40 billion of those deposits were pulled out, and by Friday the FDIC took control of the bank. It was a dramatic turn of events for a bank that served an important role in the economy.

Following these events, the FDIC has also taken over Signature Bank. Additionally, trading to begin the week of March 13th is seeing certain other regional banks come under intense selling pressure.

Uniqueness

SVB was a major source of banking and lending services for the technology sector – especially tech start-ups, venture capital, and biotech sectors. As money flowed into these areas in the past few years, SVB's deposits ballooned and this extreme tilt toward corporate deposits (rather than retail deposits) also stood out as unique in the industry. The FDIC insures deposits up to only $250,000, so for companies with deposits at SVB almost all of it is uninsured.

With deposits swelling at a much faster rate than it could loan out, SVB invested heavily in longer maturity fixed-income securities which over the past year have lost substantial value as interest rates rose. The deposit growth also came at a time when interest rates were low – exacerbating the losses on the interest-rate sensitive investments that SVB chose to make with those deposits.

Although SVB was unique, the potential ripple effects both to the economy and the banking sector are meaningful as discussed below.

Decisive Actions

On Sunday evening, March 12th, the Treasury, FDIC, and Fed announced strong measures to stem the tide of rising bank concerns. First, SVB and Signature Bank depositors will be fully protected – *both insured and uninsured depositors*. This is a major step to reduce depositor flight from other financial institutions.

Second, the Fed created a new lending facility for banks and relaxed discount window borrowing to allow banks to use their fixed income holdings (including mortgage-backed securities) as collateral *at par value*. This allows banks to meet requests for withdrawals without realizing losses on security holdings and impairing their capital position.

"Contagion" concerns

Contagion can mean different things, and it's of primary importance to understand that we are not facing a contagion risk as in 2008-2009 where one failing financial institution – due to counterparty risk and interwoven financial contracts – has a direct effect on the liquidity and balance sheet of other financial institutions.

SVB's surging deposits combined with interest-rate sensitive investments greatly exacerbated its losses, but some degree of losses on securities holdings is being felt throughout the financial sector. We do not believe that a significant risk lies with excessive losses or inadequate capital in the banking sector as a whole.

Two other "contagion" risks, however, are potentially meaningful. The first is the ripple effects through the economy as liquidity tightens up and banks become even more cautious in lending. This will likely lead to a somewhat greater slowdown in the coming months than previously expected. An offset to this concern, however, is that market expectations for Fed interest rate increases this year have now moderated. At present, we do not expect these recent developments to derail our expectation of economic stabilization by year end.

The other risk is that large depositors will move significant amounts of money away from smaller banks in favor of larger banks. Undoubtedly, this will happen to some degree as large depositors seek to ensure full and immediate access to their capital. But, we believe that the Treasury/FDIC/Fed commitment to make all depositors whole – both insured and uninsured – will extend to banks broadly and that the acute concerns present today will gradually dissipate.

In short, the actions taken over the weekend by the Treasury/FDIC/Fed go a long way to addressing the liquidity problems both presently known and those that could arise. There is not a solvency concern writ large in the financial sector. The Fed, Treasury, and FDIC should have the tools necessary to prevent the mentality of bank runs from spreading too far.

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Corporate Office:
320 S. Canal Street, Floor 12, Chicago, IL 60606

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