Economic Commentary

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Has SVB broken the Fed's rate hike resolve?

Markets were taken for a tailspin late last week with the failures of Silicon Valley Bank (SVB), Silvergate Bank, and most recently, Signature Bank. While federal authorities have moved quickly to stem the fallout on depositors, markets have, correctly or not, adjusted with expectations that Fed rate hikes may be at an end. SVB, which was the 16th largest bank in the U.S. with assets of $200 billion and as a major banker to venture capitalists, startups, and the broader technology sector, triggered the market gyrations. The other banks (Silvergate and Signature) were more heavily exposed to the risky crypto space.

The failure of SVB looks to have been a classic bank run. The bank held large scale deposits during the pandemic but invested in long-duration mortgage-backed securities which lost value as interest rates rose. The concentration of bank business in the hard-hit technology sector led to cash bleed and withdrawals as the sector capitulated with higher interest rates. To fund redemptions, pay interest on interest bearing accounts and interest on bond issuance, SVB was forced to sell off a sizeable portion of its treasury holdings and realized a loss of $1.8 billion, with a $2.1 billion recapitalization through a share offering[1].

This clearly spooked depositors and triggered further redemptions of deposits. FDIC insurance covers only $250,000 per account. As SVB catered to enterprises and large accounts, most funds were uninsured. Estimates show 90% of deposits were not covered by FDIC insurance due to size exceeding $250,000. Depositors (rationally) were exiting the bank to protect against the risk of failure, although compounding the run as a group[2].

Economic concerns surrounding the SVB failure reflected two main themes. Deposits at SVB and other banks above the threshold of FDIC risked being frozen temporarily or eroded. This could have triggered direct losses or failure at firms with insufficient working capital and impact both upstream and downstream business partners. Systemically, the downfall of SVB risked broader contagion in the banking sector if depositors feared the same fate at smaller institutions.

These risks look to have been averted. Over the weekend, federal authorities quickly shored up the banking system and confidence, albeit at the risk of increased moral hazard. The government pledged that all depositors would be made whole.

Among the measures:
The FDIC took receivership of Silicon Valley Bank and all insured deposits with near immediate availability. Uninsured depositors would be paid an advanced dividend within a week and a receivership certificate for the remaining funds. Similarly, depositors at Signature would be made whole, suggesting FDIC may become uncapped[3].

Through the Fed, a new Bank Term Funding Program was created. The program is designed to stop bank runs like that seen at SVB. This includes liquidity funding to eligible depository institutions to meet depository needs with loans of up to 1 year. Collateral would include U.S Treasuries, agency debt and mortgage-backed securities valued at par[4]. Treasury will make available up to $25 billion from the Exchange Stabilization Fund as a backstop to the BTFP.

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1 https://www.prnewswire.com/news-releases/svb-financial-group-announces-proposed-offerings-of-common-stock-and-mandatory-convertible-preferred-stock-301766247.html
2 https://www.reuters.com/business/finance/what-caused-silicon-valley-banks-failure-2023-03-10/
3 https://www.fdic.gov/
4 https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm

The risk of a broader bank run has likely been averted. However, markets have taken the latest SVB saga and federal response as confirmation that the run up in interest rates clearly broke something in the system and it is time for the Fed to ratchet back rates. Indeed, in less than a week, the 2-year yield fell from 5.0 to 4.0 per cent and the 10-year yield fell from 4.0 per cent to 3.5 per cent. Markets are pricing in a cut in coming quarters and at least a hold on March 22. This is a complete 180 from expectations of 75 bps more hikes to a cut.

While there have been clear consequences of tighter monetary policy on the economy (by design) and in the banking sector, it seems that much of the SVB saga was self-inflicted and a function of poor risk and asset liability management rather than the rate environment. The failure highlights the impact on the technology sector which is burning cash and impacting deposits, but that this should indicate a pause or reduction in interest rates is questionable. Depositors are being made whole and will continue to operate and the backstops will keep institutions running normally.

The SVB overshadowed last week's economic data of a firm but moderating labour market. The U.S. added 311,000 jobs in the month pointing to ongoing strength in hiring. This was offset by a higher unemployment rate and slowing wage growth. Consumer spending has remained strong and CPI inflation momentum picked up. The latter should remain of key concern to the Fed and its mandate despite the flurry of uncertainty driven by the latest bank failures.

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