

Banks and the financial system

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Whilst our strategies have no exposure to Silicon Valley Bank (SVB) or Credit Suisse this week we feel it necessary to provide a narrative to market movements and events surrounding the banks.

At its core, SVB experienced a run on its deposits as clients realised that it had not managed its asset base appropriately and taken risks that could lead to a risk to their deposits held by the bank. SVB's customer concentration in technology and high growth start-ups made it an unusual case. The cascade of private equity funds looking for a home in a zero interest rate world rendered SVB so awash with cash that SVB could not find sufficient places in which to invest it.

It appears that SVB management took the rather lazy approach to managing surplus cash by putting the surplus funds in a variety of long-dated mortgage bonds. As page 1. of the manual tells you, bond prices fall when interest rates rise. Thus, as the Federal Reserve increased interest rates the value of the bank assets (and therefore the security of bank deposits) declined. Naturally, depositors sought to recover their funds leading to an old-fashioned "run on the bank."

The collapse has highlighted the risks of higher interest rates for banks, which affect both sides of their balance sheets. The fall in government bond prices brought about by rising yields hurts a bank's balance sheet. Regulations brought into force following the 2008 financial crisis has limited this risk but SVB was not regarded as a "systemic" risk and thus fell outside the enhanced supervision of the Federal Reserve. It does not mean, therefore, that this is a repeat of 2008.

Credit Suisse on the other hand has been poorly managed for a long period and has been undergoing a restructuring which required further funding from its shareholders. The largest of these decided not to participate in the fundraising and the timing of this has made other investors wary. The Suisse central bank has stepped in to reassure investors that the bank is solvent and a going concern, albeit with a low prospective return for shareholders.

Some banks and businesses in this cycle are more exposed to rising bond yields and did not manage this risk as they became used to lower and lower interest rates on which they based their decisions. Many banks did not do this and also have sufficient capital to absorb such losses post 2008.

Warren Buffett once said "only when the tide goes out do you discover who has been swimming naked". This statement is true and is why we have been focused on balance sheet strength and warned against the long term capital destruction that could occur in certain areas of the markets.

Unfortunately, during periods such as this all equities fall. This is a market reaction as buyers go on strike and certain market participants are forced sellers. This period can last for a few weeks until the risks can be quantified, and prices reach a point at which buyers return. It is those equities with sound balance sheets and strong growing cashflows that are then rewarded in the recovery rather than those which have been impaired during the period.

The economic outlook has not materially altered overall however there is one material change that this week will result in: financial conditions will tighten without the need for materially higher interest rates as banks will reduce lending and this will do the same job as a rate rise would have done. A sense of perspective is needed during periods such as this – not panic. As we have highlighted above, the SVB and Credit Suisse issues stem from poor management decisions rather than a systemic risk to the financial system as in 2008. Monitoring this will be important but we do not see red flags for the longer-term outlook at present.

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