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The SVB Story – a Series of Avoidable Events

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Markets are still feeling the reverberations from the failure of Silicon Valley Bank (SVB), the second biggest US bank collapse in recent history. Its UK subsidiary, Silicon Valley Bank UK Limited, was ultimately saved because the Bank of England acted quickly, exercising its resolution powers to effect the sale of SVB UK to HSBC UK Bank plc for £1; but a shadow prevails. The speed at which deposits were transferred and sentiment changed continues to concern investors.

How did it happen?

In mid-2022, SVB started to receive increased deposits from large tech startups, which were its primary depositor base. Typically, large tech startups have large cash balances from funding rounds and venture capital (VC).

The issues started when SVB couldn't lend the elevated balances to their usual borrower base, the Silicon Valley tech sector, because of the venture capital funding craze filling their niche. As an alternative, SVB opted to purchase US T-bills, (government issued bonds), a safe asset to hold.

What subsequently happened involved the wider economic picture and heightened inflation in the US. The Federal Reserve implemented one of the sharpest and most persistent rises in US policy rate ever, amidst a backdrop of equally fast and persistent rate hikes around the world from other central banks. As a result, government bond yields started to increase, and as is the relationship with price and yield, government bond prices started to fall.

This wouldn't naturally be a problem, because most banks would hedge their interest rates risk exposure, reducing the risk. SVB did not do this, and instead opted to classify these assets as Held-to-Maturity (HTM), which meant they didn't need to account for the changes in market valuation because they would ultimately get them back at par on maturity of each loan.

The next problem arose when a series of advisors and private funds were advised to withdraw their cash and assets from SVB due to the risky situation, triggering a run on the bank. Once one depositor wants to withdraw due to a lack of confidence, so does the next, further compounding the problem (similar to Lehman Brothers in 2008 but on a smaller scale). So it begins. Once the liquid assets had been used up for depositor withdrawals, the assets held under HTM were needed to supply depositors with funds. Because these assets were not the value that they were on the balance sheet, the bank did not have enough assets to cover withdrawals. This caused SVB to collapse and brought SVB UK to the brink of collapse, shaking market confidence in the banking sector.

What does this mean for real estate investment in the UK?

- Direct impact is very limited. SVB UK had very limited exposure to real estate lending as its primary focus was on the tech sector.
- Indirect impacts include:
    - Potential contagion in the banking sector
      This has now largely been avoided due to swift action by the Bank of England using its special powers under the Special Resolution Regime in the Banking Act 2009. This legislation was passed in the aftermath of the banking crisis back in 2008 to provide a toolkit for dealing with failing banks, to reduce the risk to the wider market.
    - Loss of market confidence
      There is no doubt that this has been an unwelcome reminder of the 2008 financial crisis. Although general market sentiment is that the UK banking sector is more resilient and much stronger than 2008, the sector is still susceptible to depositor confidence. Markets do not like uncertainty and all parties have paused for thought, which in the short term may lead to less activity.
    - Tightening of credit criteria for lending
      In the short term, lenders may re-evaluate their lending criteria which could lead to borrowers needing stronger balance sheets or sponsor backing to be eligible.
    - Increased cost of borrowing
      Widening credit spreads could mean that lenders' pricing will be more expensive due to their cost of funding. Funds may find it harder to raise capital as there may be less investment appetite in the short term, while investors reassess the market.
    - Proposed regulatory changes
      The Bank of England is considering re-evaluating the deposit guarantee scheme as a result of recent events. Currently the Financial Services Compensation Scheme (FSCS) protects deposits of up to £85,000 in banks, building societies and credit unions but this only covers about two thirds of deposits. This is particularly an issue for small businesses that depend on access to funds to keep operating and paying suppliers and staff. Regulators are discussing not only the amount of the sums guaranteed, but also how to minimise timing disruption. Depending on the outcome, this could result in higher costs for lenders if a pre-funded pool model is adopted.

Lessons will be learnt from SVB. Its effect may not be as dramatic as Lehmans, but it is a timely reminder of the importance of safeguarding to ensure market confidence.