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COMMENT ON US BANK FAILURE
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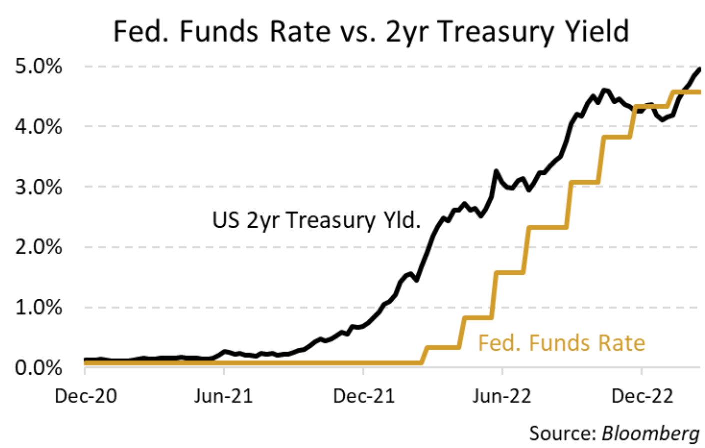
Slowly, then all at once

At the end of last week, the 16th largest bank in the US, Silicon Valley Bank, was shut down by regulators when it became clear that it wouldn't be able to stem a run on deposits. Rumours had been swirling for some time that SVB was headed toward (if not already in) violation of its regulatory capital requirement, which was precipitated by a significant duration mismatch between its liability book – i.e. customer deposits – and its asset base, represented primarily by mortgages purchased near the top of the fixed income market.



The fine details of SVB's failure are too labyrinth to cover in this update, but suffice to say that its demise triggered concern that a contagion could spread across similar institutions, especially regional banks in the US, which don't carry the broad deposit bases or stress test requirements of their much larger, money-centre peers.

Apart from SVB's lackadaisical approach to risk management, a direct line can probably be drawn between this event and the breakneck pace of the Federal Reserve's monetary tightening program. Even more taxing than the level to which short-term interest rates have climbed is the speed with which they've moved (see chart). As we suggested in our recent webinar, this backdrop has left little time for economic entities to adjust, significantly boosting the potential for unintended consequences.

Recognizing that confidence in the banking system was at risk, regulators moved quickly over the weekend to backstop uninsured deposits at SVB. This was necessary under the circumstances and should prevent SVB's uniquely poor management from becoming a destructive wave across the entire industry.

How does this affect DM portfolios?

Had the US government not stepped in to guarantee SVB deposits, the cascading loss of faith in the financial system would not only have exerted extreme pressure on bank shares, it would have likely caused the entire market to plunge in sympathy. At the time of writing, however, such an outcome seems to have been avoided.

The only US bank owned in DM mandates is JP Morgan, which carries one of the most diversified deposit bases in the industry alongside an asset pool significantly less exposed to rising rates than those of its peers.

In Canada, our banks boast very favourable liquidity positions, with coverage ratios rising by 8% on average in the most recent fiscal quarter. As well, Canadian banks experienced deposit growth of 4% in the second half of 2022 vs. a decline of 2% in the US over the same period. The asset bases of Canadian banks are also very well diversified, spread across residential and commercial real estate loans, and corporate and unsecured (credit card) lending. For these reasons, coupled with their long histories of prudent risk management, we aren't concerned about any of the bank positions in DM equity mandates.

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