State of Play

Bank collapse prompts market uncertainty

16 March 2023

After two uneventful weeks in markets, the last few days remind us of how much 'noise' retail investors face when one story can lead to a wider panic. However, is this panic justified? This week we wade through the SVB Bank collapse, the latest US inflation numbers, UK employment data and the recent UK budget. In this bumper edition, we explore the implications for savers and investors as our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Key highlights from this week's State of Play

- SVB Bank Collapse
- US Inflation update
- UK employment data
- Budget Summary

What is a bank run?

Last week, Silicon Valley Bank (SVB) provided an update to the market that prompted a surge in customer withdrawals, which ultimately led to its demise, the largest bank collapse since the Global Financial Crisis (GFC). So, why did it happen?

In my humble opinion, if someone asked me how to explain a bank run, I would usually point them to a very famous film, It's a Wonderful Life, starring James Stewart.[1] In the story, James Stewart plays George Bailey, the head of a local community bank called the Bailey Building & Loan - essentially the UK version of a building society. The film is set at the time of the 1929 stock market crash, when panic triggered people to ask for their cash all at once.

When many customers, concerned about a bank's solvency and the safety of their deposits, try to withdraw their balances at once, this drains the bank's reserves, and as more customers try to make withdrawals, the bank runs out of cash to fulfil them. This occurs because banks don't keep their customers' money in a vault, they use it to lend other customers money to buy their home or to fund operations for a local business. In the film, George uses his own personal savings to prevent the Bailey Building & Loan from going bust, but left with a single dollar, they came very close to disaster.

Northern Rock

Whilst the film is make-believe, it highlights the simplicity of the traditional bank model and how this is built on trust and confidence – and importantly, capital. So, how does this compare to the 2008 collapse of Northern Rock bank and the failure of Silicon Valley Banks (SVB) this month? In the case of Northern Rock, the moment they announced they had sought help from the Bank of England, the trust and confidence evaporated, leading to long customer queues for their savings. Eventually, both the government and the Bank of England had to step in and fund support for savers and mortgage customers until the bank was split into two. The savings part (the good part) was sold to Virgin, and the lending part (the bad part) continued to be managed by the government.[2] Although Northern Rock was the first to need help in the UK, it wasn't alone in the global financial crisis, as the UK Government and the Bank of England set about rescuing Royal Bank of Scotland and Lloyds. In addition to buying large shares of banks, the UK Government and the Bank of England, like other countries internationally, set about slashing interest rates to near-zero and printing vast sums of new money to provide liquidity – in the form of quantitative easing (QE).

Silicon Valley Bank (SVB)

Last Friday, US regulators decided to put Silicon Valley Bank (SVB) into receivership following a run on the bank triggered by some worrying updates two days before. SVB had announced it had sold some of their bond assets at a near $2 billion loss and sold more of its own shares to raise much needed capital following increasing outflows over the previous quarter as many of their technology company clients came under pressure as interest rates increased rapidly in response to inflation.[3] This update spooked shareholders and clients, triggering a collapse in their share price and an alarming $42 billion withdrawal of cash on Thursday alone. Investment markets have understandably begun to worry about the risk of contagion among banks following the second-largest commercial bank failure in US history.[3] The scars of the global financial crisis run deep, and although this happened 15 years ago and the regulations require most banks to maintain a minimum level of capital to protect against shocks such as these, it still stirs immense anxiety and the stock markets reacted accordingly.

What is the risk of contagion?

Both the US and UK authorities reacted swiftly to reassure concerned businesses who were unable to withdraw their cash in time, that their money would be protected. In the UK, the Chancellor, the Prime Minister and the Bank of England worked with HSBC over the weekend to announce a deal for them to buy the UK arm of SVB for just £1. This was then announced on Monday morning to calm markets and protect the technology sector in the UK, with HSBC promising to inject $2 billion of much-needed cash immediately.[4] Obviously, events spooked stock markets, prompting the share price of many regional banks in the US to plummet and send the banking sector sharply into the red.

However, is this panic justified? I think it is prudent to take a step back and make some important comparisons between SVB and most other familiar banks. SVB had a very unusual banking model when compared to most. Nearly all their customers were companies, specifically technology companies and venture capitalist organisations. In 2021, SVB claimed it had 50% of all venture capital-backed start-ups as customers, which represents a huge concentration risk.[3] Importantly, companies behave differently to retail customers. Most retail customers rarely change who they bank with for lots of different reasons. Corporations, however, are less loyal, always looking to seek out a better deal to improve cost efficiencies and importantly, lower borrowing costs.

The pandemic triggered a huge influx of investor money into the tech sector, helping these types of companies raise much-needed capital to grow their ideas into more established enterprises. However, with a rapidly changing monetary backdrop and rising interest rates, two key things affected SVB. Firstly, an unusually large portion of their cash was invested into long-term (normally low-risk) bonds, rather than in loans. As interest rates began to rise, so did the yield on these bonds, causing losses for SVB. If they were able to hold these assets to maturity, their losses would be less and spread out over a long-period. However, with rising interest rates, start-up companies started to burn through cash rather than borrow from banks. As an increasing number of companies began to withdraw their cash, SVB began to run out of available capital, forcing them to sell some of these bonds at a heavy loss and then their own shares to ensure they could meet the increasing demand for depositors' money. Hence, the trigger point. Once they announced to the market the steps taken to address liquidity (having enough cash), the panic began.

So, does this mean we should be worried about the financial sector like in the financial crisis? Importantly, by comparison, this appears to be isolated to SVB, given their business model. In addition, the banking sector took steps after the financial crisis, guided by the regulators, to ensure they held sufficient capital to protect against panic scenarios and ensure any concerns do not spread through the system, causing another crash. Also, the financial crisis was triggered by mortgage loans that were wrongly identified as low-risk and spiralled over many months, exposing banks' exposure to lending decisions taken prior to the crash. This time around, the trigger point has more to do with the normalisation of interest rates affecting bond assets and a business model with concentration risk than something more systemic. Whilst the banking sector shares have fallen significantly since the story broke, calm initially returned to markets at the time of writing, but following suspension of Credit Suisse shares on Wednesday the banking sector dragged other shares much lower as the FTSE 100 fell over 3% at one stage. Credit Suisse shares fell 30% to a new record low after the chairman of Saudi National Bank, which is the Swiss lender's biggest shareholder, said it could not provide additional financial support due to the regulations limiting it to holding a maximum of 10% in the group. In addition, insuring Credit Suisse's bonds against default hit a new record high exacerbating investor concerns.[4] In an effort to allay concerns about its financial stability, Credit Suisse will borrow up to £44.5 billion from Switzerland's central bank. The Zurich-based lender stated early Thursday morning that it was taking "decisive action".[5] After the Swiss government intervention, calm returned to the markets on Thursday morning.

UK employment update

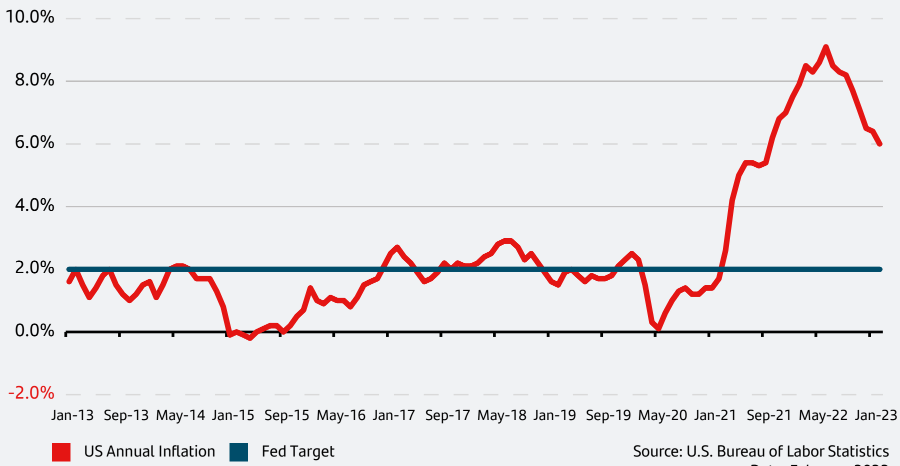
According to the Office for National Statistics, the unemployment rate from November 2022 to January 2023 was largely unchanged at 3.7%. The number of people unemployed for over 12 months increased slightly in the latest three-month period, but the inactivity rate decreased by 0.2% on the quarter to 21.3%. Importantly, in December 2022 to February 2023, the estimated number of vacancies fell by 51,000 on the quarter to 1,124,000, falling for the eighth consecutive period. This reflects uncertainty across industries, as survey respondents to the ONS continue to cite economic pressures as a factor in holding back on recruitment.[6] The vacancy rate is still very high by historic levels and is likely to remain an important factor in the Bank of England's Monetary Policy Committee (MPC) meeting next week when they decide whether to raise interest rates again.

The committee has previously expressed concerns about high vacancy levels placing pressure on employers to pay new recruits higher packages to attract the right employees. This is reflected in the latest earnings numbers, which show the rate of growth in total average pay (including bonuses) was 5.7%. When looking at regular pay (excluding bonuses) the increase was 6.5% among employees in the November 2022 to January 2023 period. Regular pay growth in the public sector stood at 4.8% compared to 7% in the private sector. In real terms (adjusted for inflation), growth in total and regular pay fell on the year by the most since April 2009.[6]

Latest US inflation data

In the US core Consumer Price Index (CPI) prices (measures the changes in the price of goods and services, excluding food and energy), rose by 0.5% month-on-month, compared to a market expectation of 0.4%. As a result, the quarterly annualised rate has risen in the last two months to 5.2%. So, although core inflation continues to show, in general, a downtrend, it seems clear that the pace of slowdown has moderated recently, especially if we compare this with the evolution that we had before the upward revision that took place two months ago, when the annualised rate had fallen to 3.1%.[7] The Fed will be mindful that fall in rising prices has slowed, but it is impossible for them to ignore the impact of the SVB failure is primarily driven by the aggressive rise in rates over the last 12 months. That is reflected in the change in market expectations for their meeting next week which was pricing in between 0.25-50%, has now changed to a maximum of 0.25%, with many predicting no change at all.

US annual inflation



Source: U.S. Bureau of Labor Statistics
Date: February 2023

Budget summary

The Chancellor of the Exchequer stood at the dispatch box in the House of Commons on Wednesday (15 March) to deliver his budget. Much of the content had been gradually leaked to the media since the start of the week, with few surprises. Below is a quick summary of the key measures affecting savers and investors, with those saving for a pension being helped significantly with the changes proposed.

Pensions

In a measure designed to discourage early retirement, the current £40,000 cap on tax free pension contributions, which has been frozen for 9 years, will increase by 50% to £60,000. Earlier in the week, the media leaked the intention to increase the lifetime allowance, but in a surprise announcement, the allowance is being scrapped all together. One of the reasons the changes have been made is the increase in the number of GPs retiring earlier because of the impact of the lifetime allowance and other penalties on their NHS pension benefits. For example, those already drawing a pension but want to save more are now allowed to save £10,000 per year, up from the original £4,000 limit.[8]

Business taxation

The rise in the headline rate of tax from 19% to 25% on company profits will go ahead on April 1, as promised in last year's autumn statement. However, businesses will be able to offset all of their UK investments in machinery, infrastructure and assets against profits for tax purposes as part of a package of measures to help limit the impact of the corporation tax rise.[9]

Green subsidies

An increase was announced of £20 billion to fund the development of carbon capture and storage projects. In addition, the chancellor confirmed that nuclear power would be classified as "environmentally sustainable" to drive investment in the energy sector and bring down costs.[9]

Energy support extended

As expected, support for energy bills has been extended by three months until the beginning of July. The existing scheme of limiting average bills to £2,500 will remain in place (the ceiling was due to rise to £3,000 a year from April), although the £400 winter discount will be scrapped. The government expects that the sharp fall in the price of wholesale gas will mean that when the support is removed, bills are not expected to rise.[9]

The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing **here**.

Note: Data as at 16 March 2023.

[1] IMDB.com, 14 March 2023
[2] Reuters, 17 November 2011
[3] Goldman Sachs, 12 March 2023
[4] The Times, 13 March 2023
[5] The Times, 16 March 2023
[6] Office for National Statistics, 14 March 2023
[7] U.S Bureau of Labor Statistics, 28 February 2023
[8] BBC News, 15 March 2023
[9] HM Government, 15 March 2023

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