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INSIGHT

The Silicon Valley Bank Failure's Capital Markets Implications

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The sudden failure of Silicon Valley Bank (SVB) and Signature Bank and troubles at several other banks (e.g., First Republic Bank and Credit Suisse) triggered a selloff of bank shares in March 2023. Regional bank shares (e.g., KBW Nasdaq regional bank index) were down nearly 20% year-to-date through March 17, 2023, while the general stock market performance (e.g., S&P 500 index) had a slight gain of 2% for the same period. As of April 5, 2023, the overall stock market indexes went up higher, but regional bank shares remained at depressed price levels (**Figure 1**). This Insight is part of a CRS product series explaining the SVB event from multiple financial services perspectives. It focuses on the SVB failure's capital markets implications.

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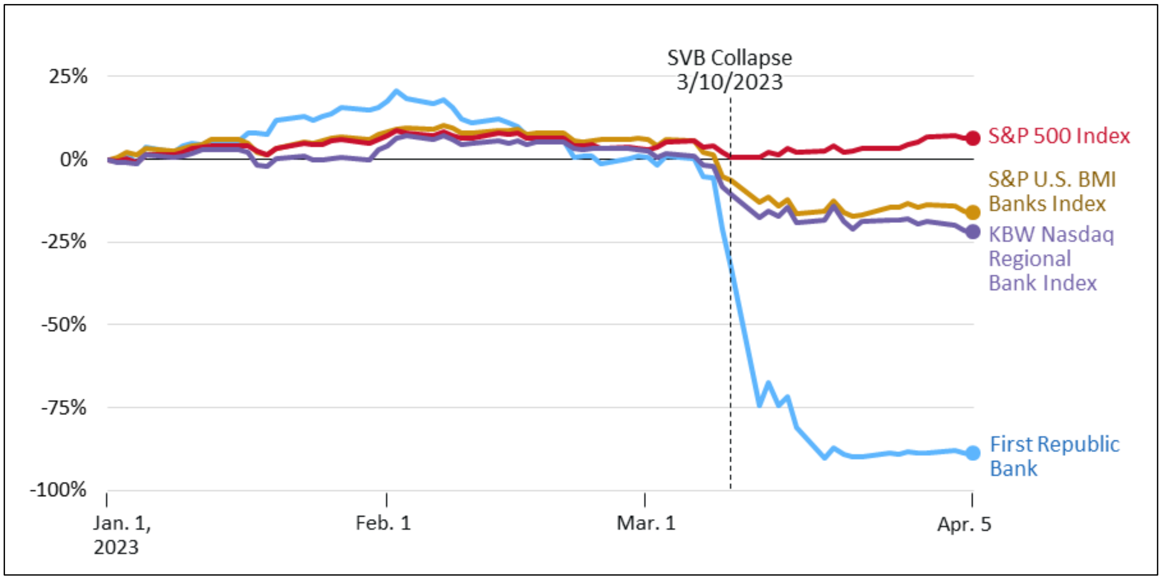
Figure 1. Market Performance Before and After SVB Failure
(1/1/2023–4/5/2023)



Source: CRS using data from S&P Capital IQ.

Many factors may have contributed to SVB's failure. Some of these factors are more unique to SVB's specific conditions (e.g., a heavy concentration of its depositor base and a high reliance on uninsured deposits) or specific to banking industry risks (e.g., a bank-run event). Other factors have broader capital markets implications. For example, SVB's failure triggered broad capital markets reactions, including the following:

- **Flight to safety.** Some uninsured deposits at the banking system reportedly moved from banks to short-term Treasuries, money market mutual funds (MMF), and gold, in search of safety. MMFs (largely MMFs backed by government securities) saw abnormal levels of inflows following the SVB failure. Certain other less-safe alternatives, such as digital assets (e.g., stablecoin Tether), also experienced inflows.
- **Market volatility.** The increased uncertainty fueled market volatility across many assets, such as bank stocks and Treasury securities. Market volatility normally would not warrant policy attention, unless it reveals perceived structural vulnerabilities. For example, the GameStop event in 2021 has led to a number of legislative proposals and SEC-proposed rules. One area during the March 2023 banking sector selloff that may warrant a close watch is the liquidity conditions in the Treasury market that have showed signs of vulnerability.
- **Contagion effects.** Some observers are concerned that the SVB failure may adversely affect the technology startups' funding and operations. SVB directly affected its depositors, such as tech industry companies Roku, Roblox, and Rocket Lab USA, which reportedly deposited $487 million, $150 million, and $38 million respectively at SVB. Given the magnitude of the impact, some publicly traded companies filed an SEC Form 8-K to disclose their *exposure* or *no exposure* to SVB. The collapse also de-pegged stablecoin USDC because of Circle's deposits at SVB. The run fear generated tension at similarly situated banks and across the banking system, leading to the pressure on additional bank failures and banking sector stock price volatility. At a broader level, the SVB failure, or similar events, could often erode market confidence that underpins the

whole financial system's liquidity and risk pricing. The related government actions to address contagion effects appear to have backstopped a broader market selloff.

- **Fear of a rising interest rate environment.** For more than a decade (before the recent rate hikes), the prolonged near-zero interest rates were thought to have driven up asset valuations for stocks, bonds, and real estate, creating a perceived "everything bubble." The sudden increases in interest rates coming out of the "cheap money" environment cause long-maturity assets with locked-in low yields to decrease in value. Such an asset-liability mismatch is a type of market risk exposure that is broadly felt by different asset holders, including other banks, and the amount of high-market-risk assets within the financial system could be significant. In addition to issues at banks, corporate defaults are also reportedly on the rise. One area that is particularly prone to rising rates is the zombie companies, which face higher pressure from debt servicing costs (derived from higher interest rates) that may push them over into default.
- **Tightening of credit conditions.** Following the SVB failure, the banking sector has reportedly tightened lending standards for businesses and households, possibly leading to less provision of funds to the real economy. As sources of financing that are an alternative to bank lending, capital markets fundraising channels have also faced pressure from a potential credit crunch, which reduces the general availability of credit from financial institutions, including bank loans and non-bank financial intermediation. Certain business segments, such as commercial real estate, have already felt the pressure. One concern is that the reduced availability of financing has the possibility to adversely affect default rates and the mortgage-backed securities market's performance, leading to potential asset fire sales and negative self-reinforcing cycles for asset pricing.

One common question is—does SVB represent a "canary in the coal mine"? In other words, instead of being an isolated case, does the SVB failure reveal broader structural instability in capital markets? The answer to this question rests on the interpretation of implications of recent changes in the costs of fundraising, asset valuation, the size and composition of institutions' assets, and the debt servicing costs for institutions' liabilities.

As of the time of this publication, the *overall* stock market performance, as measured by broad market indices, has not been strongly affected, although events are still unfolding. Regarding how the events would further unfold, some observers believe SVB's failure could have ripple effects on smaller regional banks, causing them to tighten lending standards and reduce lending, leading to another potential deleveraging cycle that could affect the financial system and economy broadly. Others believe that at the current stage of the debt cycle, when certain conditions are met, contractions are likely. Treasury Secretary Janet Yellen has argued that the SVB failure is very different from the Great Recession and the financial system is "significantly stronger than it was 15 years ago." She reportedly affirms the possibility of further intervention, if needed, to support smaller banks. Such promise of potential interventions could help calm markets.

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