Frances Cheung
Rates Strategist
+65 6530 5949
FrancesCheung@ocbc.com

Christopher Wong
FX Strategist
+65 6530 4367
ChristopherWong@ocbc.com

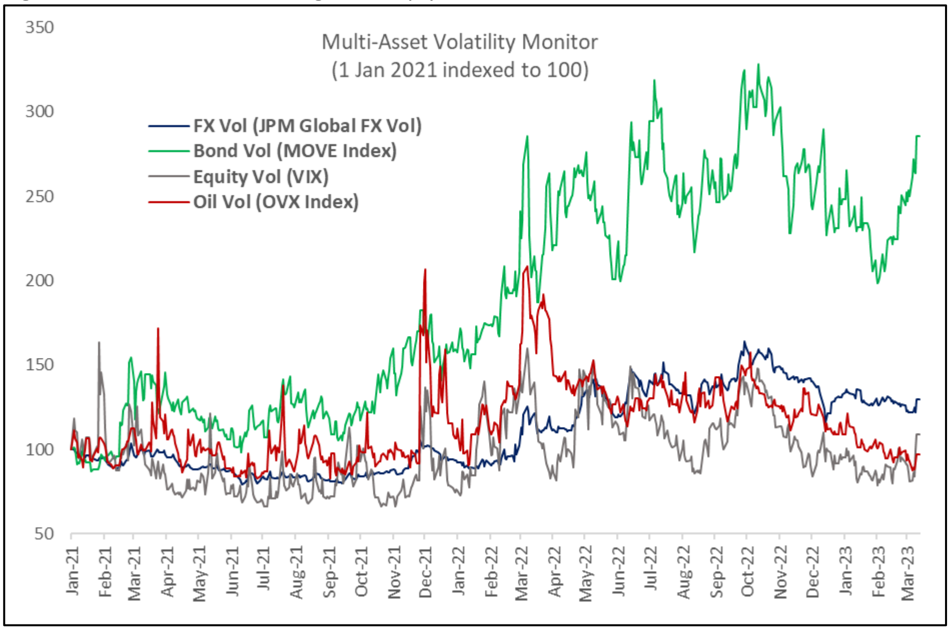
Andrew Wong
Credit Analyst
+65 6530 4736
WongVKAM@ocbc.com

Market Implications of SVB Incident

Background

- Market assumptions at the moment are tenuous at best and have been upended by the recent developments at Silicon Valley Bank ("SVB") that failed last Friday, 3 days after the release of its Strategic Actions/Q1'23 Mid-Quarter Update. SVB is the second largest US bank failure in history after Washington Mutual in 2008. The Federal Deposit Insurance Corporation ("FDIC") took control of SVB on Friday amid a run on deposits and a failed attempt to raise capital.
- SVB's sudden collapse raises concerns about vulnerabilities in the banking sector to rising interest rates. Over the weekend, stablecoins such as USDC, Dai have broken their peg with the dollar, Signature Bank was shut (3rd largest US bank failure in history) by regulators due to systemic risk while the 4 biggest US banks lost over USD50bn in market value and KBW Nasdaq bank index (of 24 leading banks in US) saw its largest decline since pandemic. Last week crypto bank Silvergate also announced voluntary liquidation.
- The impact on rates, FX and credit markets stems from uncertainties surrounding the outcome of SVB's collapse and the influences of idiosyncrasies and contagion effects. While prompt actions by regulators have however somewhat reduced these uncertainties, market impacts will continue to be felt.

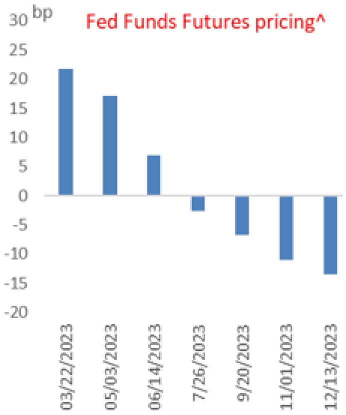
Figure 1: Bond Vols Have Surged Sharply



Source: Bloomberg, OCBC Research

Rates implications

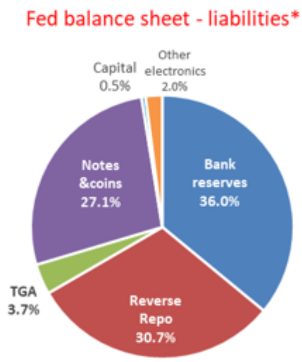
- **Key is to contain contagion:** The 2Y UST yield has fallen by a cumulative 66bp since the recent high on 8 March, and the 10Y yield by 33bp, as safe-haven flows flocked into the sovereign bonds while market also re-priced lower the Fed Funds rate trajectory. Price actions remained choppy during Asian hours. US authorities have announced actions to protect deposits, with a view to reassuring depositors and thereby containing any contagion to other depository institutions and the broader economy. Indeed, the key is to shore up confidence and prevent the spreading of bank runs. Should market sentiment stabilize, then investors will refocus on the data. To recap, labour market reports on Friday were a mixed bag; while payroll beat expectation, average hourly earnings unexpectedly decelerated and jobless rate edged higher alongside the labour force participation rate. The next to watch is US CPI on Tuesday, with particular focus on whether the disinflation trend has continued.



Source: Bloomberg, OCBC research
^13 March 2023

- **Protect deposits**: There are three main parts in the joint statement by US Treasury, Federal Reserve and FDIC. 1/ FDIC is to “complete its resolution of Silicon Valley Bank” so depositors will have access to all of their money starting Monday 13 March; a similar risk exception for another bank was also announced. 2/ Shareholders and certain unsecured debtholders will not be protected. 3/ the Fed will make available additional funding to eligible depository institutions to help assure banks have the ability to meet the needs of all their depositors. There is a separate statement on this: the additional funding will be via a new Bank Term Funding Program (BTFP), offering loans of up to one year to depository institutions pledging USTs, agency debt, mortgage-backed securities etc, at par value.

- **FOMC policy rate decisions:** Going through Powell’s testimony and the latest financial market development, our base-case has been a 25bp hike at the March FOMC meeting. Our view has been that a smaller rate hike at a time would provide the FOMC with more flexibility to gauge lagging impact of previous rate hikes, especially when the inflation outlook is highly uncertain. The latest development in the US banking sector is complicating the Fed’s rate hike decisions. While the Fed’s dual mandate is inflation and employment, the implications of various rates levels on the distribution of liquidity across assets/tenors cannot be ignored. For example, there are USD2trn plus of funds parked at the Fed’s o/n reverse repo facilities, which is paying 4.55%. We have expected higher yields on other market instruments will attract some funds away from this overnight facility over time. That said, in the scenario where market liquidity is impacted materially, different adjustment to administered rates compared to that to the Fed funds rate target range cannot be ruled out.



Source: Bloomberg, OCBC research
*as of 8 March 2023

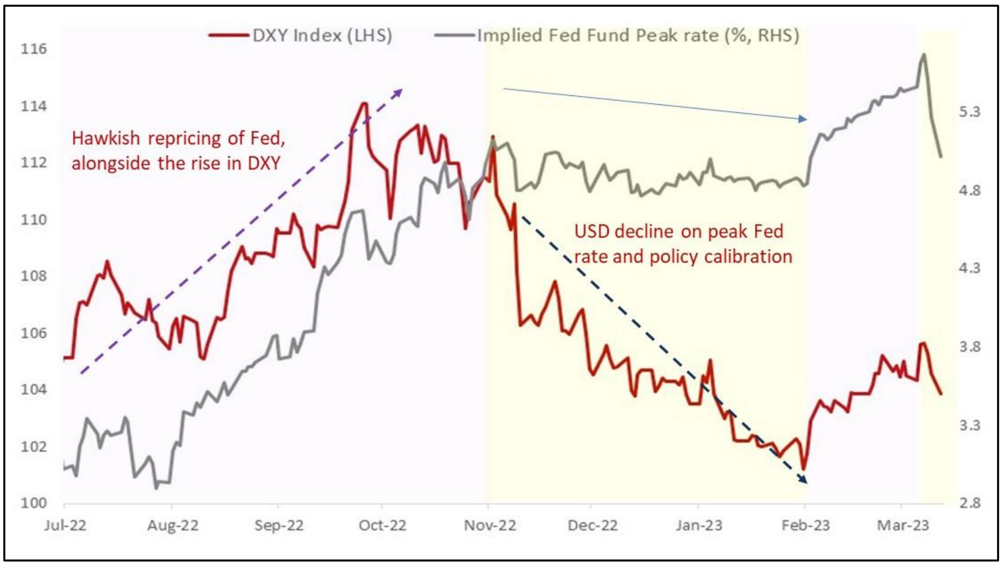
- **USD liquidity**. For now, liquidity appears to have remained supportive, not least because the Fed’s balance sheet is still huge. There has been some downward pressure on basis swaps, including those in the EUR, KRW, SGD and TWD markets, but movements have thus far been timid. As the Fed’s balance sheet continues to shrink amid ongoing QT, movements in some other components on the liability side of the Fed’s balance sheet can potentially mitigate the impact on bank reserves. Most notable is the usage at the Fed’s overnight reverse repo facility mentioned above, while the TGA (US Treasury’s cash balance) can also fluctuate. The basis market and various swap lines usage – offered by local central banks and by the Fed – will continue to provide indication of the market USD liquidity condition and of any sign of contagion risk.

- **Asian LCY government bonds**. Asian local currency government bonds have thus far benefitted mildly from the UST rallies through more favourable yield differentials and a weaker dollar. The lower basis may help asset swap trades at the margin, potentially adding to inflows into the domestic bonds; asset trades look relatively more viable in the KRW and MYR markets into KTBs and MGS. But again, investors shall watch out for any sign of contagion risk which will affect flows into Asian markets.

FX implications

Currency markets are calmer than expected. Contagion risk is limited so far and SVB failure being a **US-centric risk tends to weigh more on USD**. Fears of market contagion and stresses may even prompt Fed officials to reconsider the pace of hike at the upcoming FoMC as preserving financial stability takes precedence. The rapid dovish repricing of Fed hike expectations (only 25bp expected at Mar FoMC and a much lower peak rate of 5.07% (as of writing) further weighs on the USD.

Figure 2: USD can fall when Fed Fund Target Rate Has Peaked



Note: Pink shaded portions refer to hawkish repricing and USD strength while yellow shaded portions refer to peak in Fed rate or policy calibration/ dovish repricing of the Fed and USD softness
Source: Bloomberg, OCBC Research

Safe-haven proxy including JPY, CHF and gold will remain better bid amid ongoing concerns of bank run and banking stress could see risk aversion flows. **AxJs, including AUD can benefit thanks to lower UST yields and softer USD**. But we remain watchful as high-beta FX such as AUD, KRW can be subjected to sell-off on any signs of contagion or global risk off (such as broadening sell-off in global equity markets, etc.).

Looking on, focus shifts to 1/ US CPI on Tue. Slower rise in price pressures can reinforce the disinflation narrative and that may offer further reassurance for markets to price in a less aggressive tightening path, alongside a softer USD. But the risk is a hotter than expected US CPI as that could revive expectations for a hawkish Fed. This would lead to UST yields running higher and that provide support for USD. 2/ We also keep in view **China activity data on Wed**. A stronger data print would lend support to China reopening narrative and is likely to see positive spill-over to Asian FX, including AUD.

Credit implications

SVB's collapse was fast – within 3 days of the release of its Strategic Actions/Q1'23 Mid-Quarter Update. Government and other support actions were even quicker, coming two days after the bank's takeover by the local regulator. **Given the prompt actions by regulators, the contagion impact will likely be contained in our view and the focus will shift more comfortably to SVB's idiosyncrasies.** That said, we take several outcomes from the recent whirlwind of developments.

Ongoing pragmatism of regulators and the implementation of regulations

While the intention of current banking regulations post the Global Financial Crisis is to bail in and not bail out, regulators will not cut off the nose to spite the face in our view. This sentence in the joint statement from the US Treasury, Federal Reserve and FDIC that relates to Signature bank that “All depositors of this institution will be made whole. As with the resolution of Silicon Valley Bank, no losses will be borne by the taxpayer,” highlights that in times of need, regulators will be creative in implementing bail in regulations to preserve systemic risk.

As we have covered previously, regulators are pragmatic in protecting systemic risk and we saw this most recently during the pandemic when another type of potential contagion resulted in the relaxation of various prudential requirements by Financial Institution regulators to create balance sheet buffer for Financial Institutions to continue lending. Pre-pandemic, we also saw selective use of existing bank resolution regulations in 2017 depending on idiosyncratic developments in Europe (please refer to our Singapore Mid-Year Credit Outlook 2022 for full details).

What these examples show is that regulator decision making is driven by practicalities and idiosyncratic factors rather than theory with regulators using the flexibility within their regulatory frameworks as well as ongoing pro-active oversight to ensure systemic stability. This is despite regulator intent to reduce taxpayer burdens for financial sector stress and eliminate moral hazard as included in global bank resolution regulations. This has seen regulators use the same bank resolution mechanism, or the flexibility within their regulatory frameworks, to achieve different outcomes specific to the circumstances at hand.

Continued selectivity in credit markets

Recent developments appear more like a reflection of current sentiments within global credit markets. While investors started 2023 with cautious optimism (and an emphasis on optimism), this has slowly shifted towards caution as 2023 rolls on and rates volatility continues against still strong economic prints (albeit against decelerating inflation). While secondary prices are holding, this is more a function of limited primary market supply and concentrated primary issuances than any conviction around the market’s direction. Underlying market liquidity remains solid but highly selective and fragile amongst prevailing uncertainty.

We think the undercurrent of concern and selective market liquidity will continue to drive a flight to quality for both fundamental and technical considerations. Our conviction continues to be for a bottoms-up approach with persisting recession and geopolitical risks in the context of higher interest rates and tighter liquidity. While moving up the credit curve, we remain wary of those issuers with earnings vulnerable to tighter funding conditions.

Higher regulatory scrutiny and costs

SVB’s concerns highlight the exposure of an organisation to interest rate risks and the ability to shield them from view as part of their assets. We expect higher regulatory scrutiny on the value of a Financial Institution’s assets, in particular their holdings of government securities and treasury bills and bank and corporate securities. The classification and valuation of these holdings (and their duration) against short term liabilities such as deposits will likely be a measure for investors to monitor, especially in a rising rate environment, with implications from a liquidity, funding and capital perspective. SVB’s unrealized losses on its fixed income securities grew from USD1.3bn to USD15.2bn over the 12 months to December 2022.

Looking at SVB’s asset composition, which was heavily skewed to its investment portfolio, 55% of this was parked in Agency Registered Mortgage Backed Securities, which were more sensitive to interest rates than standard US treasuries as, when interest rates rise, borrowers will likely decide not to refinance, turning them into longer dated securities. Per its 10-K, around 79% of its fixed income securities had a maturity of over 10 years (including available for sale and held to maturity investments). More or improved disclosure on interest rate risk in the banking book ("IRBB") may be likely.

Finally, regulatory costs (both direct and indirect) will continue to increase. These costs have been increasing given Financial Institutions systemic importance and rising systemic risk from higher rates and leverage. But this risk will be somewhat quantifiable in the US with the joint announcement by the US Treasury, Federal Reserve and FDIC that losses to the Deposit Insurance Fund from SVB will be recovered by a special assessment on banks.

Emphasizing the "G" within Environmental, Social and Governance analysis

As mentioned above, regulators were pragmatic towards Financial Institutions during the pandemic through relaxation of various prudential requirements and providing emergency liquidity. At the same time though, various regulators cancelled shareholder distributions to reinforce efforts to protect capital. This highlights the two way relationship between the financial sector and the government, and the highly regulated nature of the banking industry given their systemic importance in keeping the economy going.

However, while regulation existed, the corporate governance issues surrounding SVB, and the causes of its failure should present good materials for case studies for both ESG considerations and of how to avoid a bank failure. This is because the cause of SVB's failure were established in an environment conducive for them. One that lacked adequate control mechanisms and monitoring of risk taking. As we covered in our Singapore Credit Outlook 2023, Financial Institutions' critical service and high systemic importance has created the need for strong regulatory oversight but combined with a business model built primarily on confidence and trust, governance Influences on Financial Institutions are equally important and enduring. This is to ensure there is an appropriate corporate culture and adequate risk management and financial strategies so that Financial Institutions' higher business risk can co-exist with its systemic importance and avoid any regulatory breaches or worse, a crisis of confidence as seen with SVB.

Governance quality is also enshrined in regulations. In its guidelines on corporate governance, the Monetary Authority of Singapore highlighted that "Corporate governance, especially in financial institutions, is essential in guaranteeing a sound financial system, capital markets, and sustainable economic growth. Governance weaknesses at financial institutions can result in the transmission of problems across the finance sector and the economy." Also, "Weak governance may not only undermine public confidence in that particular Financial Institution, but the financial system and markets in which it operates as well."

This potential transmission of risk through contagion concerns was the driver for the prompt actions by regulators to address market concerns on the collapse of SVB in both the US and UK. It superseded the idiosyncrasies of SVB's circumstances, as relevant as they might be.

A reminder of the key credit fundamental of diversification

It is arguable that if corporate governance were effective through risk oversight and adequate reporting then this reminder about the key credit fundamental of diversification would not be necessary. However, the developments and distress of SVB highlight how elevated concentration can lead to accelerated credit stress. In SVB's case, this concentration risk was two-fold – its concentrated customer base was subject to the same industry pressures and its concentrated investment portfolio in long term securities subjected the bank to outsized unrealized losses. Bank depositors as well will be reminded of the importance of diversification in deposits against the potential failure of a Financial Institution that can be as rapid as SVB.

<u>Explanation of Issuer Profile Rating / Issuer Profile Score</u>

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7-point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Please note that Bond Recommendations are dependent on a bond's price, underlying risk-free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

<u>Explanation of Bond Recommendation</u>

Overweight ("OW") – The bond represents **better relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Neutral ("N") – The bond represents **fair relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Underweight ("UW") – The bond represents **weaker relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

<u>Other</u>

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Treasury Research & Strategy

Macro Research

Selena Ling
Head of Strategy & Research
LingSSSelena@ocbc.com

Tommy Xie Dongming
Head of Greater China Research
XieD@ocbc.com

Keung Ching (Cindy)
Hong Kong & Macau
cindyckeung@ocbcwh.com

Herbert Wong
Hong Kong & Macau
herberthtwong@ocbcwh.com

Ong Shu Yi
Environmental, Social & Governance (ESG)
ShuyiOng1@ocbc.com

Jonathan Ng
ASEAN Economist
JonathanNg4@ocbc.com

FX/Rates Strategy

Frances Cheung
Rates Strategist
FrancesCheung@ocbc.com

Christopher Wong
FX Strategist
christopherwong@ocbc.com

Credit Research

Andrew Wong
Credit Research Analyst
WongVKAM@ocbc.com

Ezien Hoo
Credit Research Analyst
EzienHoo@ocbc.com

Wong Hong Wei
Credit Research Analyst
WongHongWei@ocbc.com

Chin Meng Tee
Credit Research Analyst
MengTeeChin@ocbc.com

Co.Reg.no.:193200032W