INTUITION
17 MARCH 2023

Can you bank on this?

Billed as the 2nd and 3rd-largest bank failures in US history (this list excludes Lehman Brothers for some reason) financial markets were rocked last week by the failure of Silicon Valley Bank (SVB), and a few days thereafter, by the failure of another regional US bank, Signature Bank, in New York. There is no doubt that bank failures are unnerving, to say the least. Memories of the Global Financial Crisis (GFC) come flooding back – and those are not pleasant! At a recent client seminar, we were asked the question whether the failures in the US would impact our own banks. This week we delve into that issue.

Michael Porter

I will admit that I had never heard of Silicon Valley Bank (SVB) prior to last week, yet according to the Federal Deposit Insurance Corporation, it was amongst the top 20 banks in the US. It was started in 1983 and specialized in providing finance to venture-capital firms focused on the technology and healthcare sectors. Over its 40-year lifespan, it had grown to amass assets of over $200 billion and deposits of $175 billion. Yet last Thursday it made headlines for all the wrong reasons. The bank experienced a run on deposits. Two days later it was bankrupt and taken over by the Federal Government.

How can this happen? How can an institution that is 40 years old collapse in just two days? Essentially, it all comes down to one simple word – trust! Modern banking systems depend on trust. Customers deposit money into banks, and banks subsequently lend it out. All banks lend more money than the deposits they have. Provided those deposits remain stable, and customers have confidence in their institution, the bank functions normally. But if those deposits are suddenly withdrawn, for whatever reason, then banks collapse. Bank failures almost always follow the same pattern, although the trigger can vary.

The demise of SVB can be summarized in a few short points:

1. SVB's client base was mostly venture capital firms in the technology and healthcare sectors. These firms had raised huge amounts of cash in the good times when interest rates were zero and deposited the cash into their bank, often SVB. SVB kept a small amount of these deposits in cash and used the balance to buy US Treasury bonds. Those promised steady returns provided interest rates remained low. As we all know, they didn't.
2. Because its clients were concentrated in the tech industry, trouble started when funding for tech companies started to dwindle. The allure of tech has faded over the past eighteen months. Consequently, its clients (tech firms themselves and often the CEOs of those firms as well) started to withdraw cash to fund operations. In some instances, deposits were large, far more than the $250,000 insured by the regulators. Remember that SVB only kept a small proportion

SPEED READ

- **Two regional banks in the US - Silicon Valley Bank and Signature Bank – have failed in the last week. That has rekindled memories of the GFC and caused markets to tumble.**
- **In both cases, poor risk management was largely to blame, as the banks did not respond adequately to changing market conditions.**
- **Basle III is a global set of standards that are designed to ensure the stability of the banking sector. In addition to the minimums set by Basle III, the South African Reserve Bank requires local banks to operate far more conservatively.**
- **Our banks operate more conservatively than what the SARB requires. This should allay any fears that our banks are vulnerable to US events.**

of its deposits in cash. So as cash was withdrawn, it was forced to sell its US bonds to plug the gap – but those sales were at a huge loss because of interest rate changes.
3. When it revealed those huge losses on Wednesday last week and tried to raise fresh capital by way of an issue of new shares, clients panicked and started withdrawing their cash as quickly as possible. The result was a run on the bank and its collapse two days later.

This might seem like an isolated example, but two days later, regulators forced Signature Bank (SB), based in New York, to close. Similar to SVB, Signature had many clients with deposits far in excess of the insured threshold of $250,000. Furthermore, like SVB, Signature had diversified and started taking deposits of crypto assets, against which it was lending out money to its clients. That was a fateful decision given the collapse in the crypto markets last year after the collapse of FTX cryptocurrency exchange. Like SVB, SB's clients panicked and started withdrawing their deposits. The bank could not honour those withdrawals, and hence the regulators were forced to step in.

Despite the differences, there is a very clear common thread in both these cases – a dismal failure of risk management. In both cases, the banks took deposits and used them to invest in assets that were stable in the good times but proved to be very volatile as interest rates increased. One might think that the CEO is the most important job in any organization. In most cases, that might be true. In a bank, one could argue that the Chief Risk Officer has the largest responsibility. Interest rate risk was not hedged, and the client base was too concentrated. Furthermore, in 2018 the US actually reduced compliance rules for small and regional banks – hard to believe given that the GFC occurred less than ten years prior. Regulators and the government have been quick to step in – essential to allow the dust to settle and prevent mistrust spreading from one institution to another. For the time being, this appears to have steadied the ship. There is no reason why other banks should be vulnerable, provided that they have implemented appropriate risk policies.

So where does that leave our banks? Clients will know that our banks have been a bright spot in the local market over the last year. Higher interest rates and relatively buoyant demand have seen interest income soar, whilst bad debts remain reasonably well contained. A return to normal conditions post Covid has seen fee and commission income recover, which has also helped the banks to improve efficiencies. The net result – strong earnings growth from our banks. In most cases, banks have reported record results and record dividends. Will events in the US derail them?

In our opinion, drawing comparisons and extrapolating events between regional banks in the US and our banks is flawed, for various reasons:
1. The US has hundreds of regional and small banks. Our banking sector is largely made up of five dominant competitors, six if you include Investec.
2. Consequently, all our banks have large, diversified

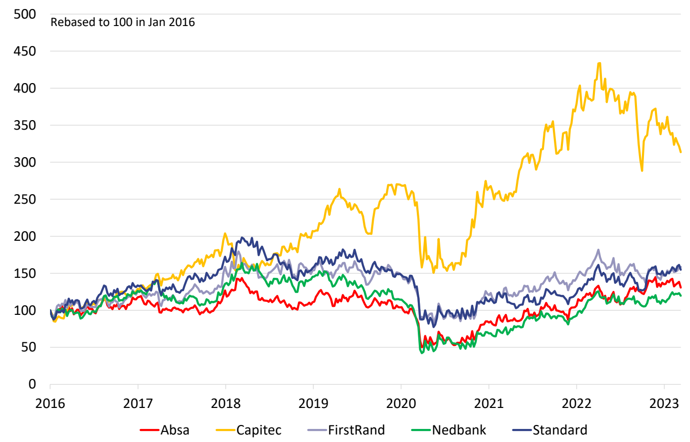
Criteria	ABSA	Capitec	FirstRand	Nedbank	Standard
Core Tier 1 Capital					
Basel III Minimum	6%	6%	6%	6%	6%
SARB Minimum	8.5%	8.5%	8.5%	8.5%	8.5%
Bank's Internal Policy	11% - 12.5%	Not disclosed	11% - 12%	11% - 12%	>11%
Current Actual rate	12.8%	35.4%	13.2%	14.0%	13.5%
Total Capital					
Basel III Minimum	8%	8%	8%	8%	8%
Current Actual Rate	16.6%	36.3%	16.0%	18.1%	16.6%
Liquidity – Funding Ratio					
Basel III Minimum	100%	100%	100%	100%	100%
Current Actual rate	113.4%	220.5%	120%	119%	124%
Liquidity – Coverage Ratio					
Basel III Minimum	100%	100%	100%	100%	100%
Current Actual rate	124.6%	2603%	120%	161%	147%

client bases that consist of both retail clients (like you and I) and corporate clients. Even within corporate clients, banks will have a spread between large, listed companies and small companies with just a handful of employees.
3. Our banks operate well above global regulatory minimums.

Clients might have heard the term "Basel III" in the financial press. This was a set of regulations introduced by global central banks after the GFC. It aimed to improve the safety of banks by ensuring that banks had adequate capital, leverage and liquidity to survive periods of undue financial stress. Banks are essentially required to exceed the Basel III minimums with regard to levels of capital, liquidity and funding. What is encouraging is that local regulations, monitored and implemented by the Reserve Bank, require more stringent minimums to take account of country-specific risks in SA and the fact that we are an emerging market. Yet as the table above highlights, all our banks are significantly more conservative that even what the SARB requires. In all cases, Core Tier 1 Capital levels are double the minimum imposed by Basel III. When commentators point to the fact that South African banks are extremely well regulated and conservative, that is not a throw-away comment. It is a fact.

In conclusion, despite the issues in the US, we firstly don't believe that this is a global systemic issue similar to that experienced in the GFC. Rather, we believe this to be limited to regional banks in the US and largely due to a failure of internal risk management at those institutions. Provided trust can be restored, this should not cascade throughout the industry. Secondly, our banks remain extremely well capitalized and profitable. The reporting season just concluded highlighted the tailwinds that banks are enjoying – better interest income, strong growth in loans (from demand for solar, amongst other things), and still benign bad debts. Understandably, our banks have sold off in response to global events. That is unavoidable and a function of being part of a global community. Rather than running for the hills, we view this as an opportunity.

SA BANKING SECTOR PERFORMANCE



Capitec outperformed its peers for many years due to its sector-leading growth. That outperformance has ended as the profitability of traditional banks continues to recover after Covid. Yet despite reporting record profits and dividends, the banking sector remains well off the highs reached in 2017.

Silicon Valley Bank's failure has sent a ripple through the global banking sector despite its narrow focus and client base.

Our next Insight seminar will take place in June and provide an update on what has driven markets over the first six months of the year, and what might lie ahead for the balance of the year. We are very excited to be expanding our seminar program to Cape Town.

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Topic:	Mid Year Market Update
Natal Midlands	
Date:	Thursday, 22nd June 2023
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm
Johannesburg	
Date:	Tuesday, 13th of June
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am
Cape Town	
Date:	Wednesday, 14th of June
Venue:	To Be Confirmed
Time:	To Be Confirmed

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