EMERGING MARKETS DEBT | INTERNATIONAL/GLOBAL

Are EM Banks Susceptible to the Same Risks as Silicon Valley Bank?

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New York - The recent collapse of Silicon Valley Bank (SVB) and Credit Suisse underscores the resilience of emerging markets (EM) banks, which operate in fundamentally different ways. While emerging markets are not immune to the heightened volatility in the macro economy from the recent bank failures and are subject to the heightened risks associated with investing in emerging markets compared to more developed economies, we believe wider contagion to EM banks is limited.

In this Q&A, we offer insights into the fundamental and structural differences between EM banks and highly specialized banks like SVB.

Could EM banks be potentially exposed to risks similar to those experienced by Silicon Valley Bank?

We believe EM banks are unlikely to become exposed to similar risks. The EM investment universe comprises banks built on traditional universal banking models, including many with well-diversified deposit bases. SVB was a highly specialized lender whose fortune was strongly correlated with the ups-and-downs of a single industry.

Are EM banks vulnerable to a run-on-deposits scenario?

In our view, while all banks are potentially vulnerable to a run-on-deposits scenario, many EM banks have systematic and structural safeguards that help mitigate such risks. First, for many, the deposit base is well diversified. Second, a significant percentage of these deposits are insured by the local deposit insurance schemes.

It is also important to note that competition for deposits in many EM countries is also much less intense because a handful of banks hold most of the deposits. While gold can be a preferred medium of savings for many EM economies, investment alternatives to bank deposits, such as money markets, are quite limited.

Could EM banks rely on support from their governments and regulators?

We believe that EM governments will provide support to their largest banks in order to preserve economic and social stability in their countries. Since most deposits are held at a few banks in many EM countries, the sector is quite concentrated, which could present a systemic risk if these institutions are not supported.

EM banking is dominated by systemically important banks that are subject to rigorous regulatory oversight, scrutiny, and supervision. Basel III liquidity ratios, such as Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratios (NSFR), have been introduced and mandated. LCR aims to promote the short-term resilience of the liquidity risk profile of banks, and NSFR seeks to reduce funding risk in the longer term. In the U.S., these requirements were removed for relatively smaller banks such as SVB.

Are EM banks exposed to large unrealized losses in their hold-to-maturity (HTM) portfolios?

In our view, most EM banks have small and manageable exposures to unrealized held-to-maturity (HTM) losses. EM banks' trading books are typically around 20% to 25% of total assets, which is less than half of SVB's securities portfolio, which represented about 57% of total assets. EM banks are also prone to take less duration risk, as most domestic government and corporate bonds in their markets are floating-rate assets, linked to either inflation or an interbank rate.

Long-term fixed-rate securities, such as those found in many developed world markets, are less common in emerging markets. EM banks are also more accustomed to the volatility of local policy rates, and rarely experience a prolonged zero-interest rate environment.

Could investors in EM banks bear similar losses to those experienced by holders of Credit Suisse's AT1 bonds before common shareholders do?

That depends on the local regulation. We believe it is possible that investors in EM banks could potentially face a scenario similar to Credit Suisse breaching the hierarchy of stakeholder claims. With the exception of Hong Kong and Singapore in bank resolution scenarios, EM countries don't have bank resolution or liquidity event legislation that guarantees and protects the hierarchy of stakeholder claims.

Language in the prospectuses of EM bank AT1 and T2 bonds gives regulators the subjective right to trigger writedowns in a recapitalization effort during a liquidity event similar to the one experienced by Credit Suisse, even if the financial institution is solvent. Under the UBS acquisition, holders of Credit Suisse AT1 bonds will be fully written down, while common shareholders will receive $3.23 billion.[1]

Insolvency legislation in Hong Kong and Singapore protects the hierarchy of claims in the resolution of a bank, but this type of protection does not appear to extend to a liquidity event scenario.

Bottom line: The EM bank universe is composed of "national champions" with well-diversified, traditional banking models. Operating under a very different model and stricter regulations, we believe that EM banks are unlikely to be exposed to the same risks as SVB, but EM banks could face a breach of the hierarchy of stakeholder claims similar to Credit Suisse. While similar risks are limited, the intersection between sovereign and corporate analysis on the MSIM Emerging Markets Debt team is crucial to effectively navigate the wide dispersion among countries and credits in the EM universe.

[1] Source: Reuters as of 3/19/2023.

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