April 2023 – Banking 2008 Redux?

"If you are in banking and lending, surprise outcomes are likely to be negative for you".
– **Nassim Nicholas Taleb (Author of "The Black Swan")**

Another banking crisis?

The month of March saw the collapse of three banking institutions in the United States: one, Silvergate Capital Bank opted for voluntary liquidation while the other two, Signature Bank and Silicon Valley Bank (SVB), were closed by regulators. Overseas, Credit Suisse is selling to UBS, another Swiss bank. While the causes of these demises generally varied for each bank, for the purpose of this discussion we will focus on SVB which was the largest bank in the United States to fail since the Great Recession of 2008, and whether its failure is the start of something larger.

SVB was founded in 1983 with headquarters in Northern California and had sixteen branches and offices. It served 50% of venture capital funded technology and life science companies in the United States. Its customers included Cisco, Airbnb, Pinterest and Block. While it was the sixteenth largest bank it was relatively small compared to the behemoths such as J.P. Morgan, Bank of America, Citigroup and Wells Fargo.

Banks are financial companies in the business of gathering deposits and making loans to businesses and individuals and investing any remaining deposits in either government bonds or mortgage-backed securities, etc. The difference between what the banks pay to depositors and what they earn from loans and investment securities is the net interest margin earned. Since many of the deposits can be withdrawn on demand, banks should manage their balance sheets to be prepared for withdrawals. But what happens if many depositors ask for their money at the same time, and the bank has loans and investments which are not available to client demands? This creates a serious mismatch or liquidity issue and could cause the bank to incur real losses by selling its investment securities at a discount. Such losses eroded all SVB's capital causing it to be bankrupt. We do not think there was anything wrong with SVB's assets and liabilities except they were mismatched. It's like you bought a new house with a loan that had to be repaid whenever the lender wanted you to, but your old house wasn't sold. Where do you get the money to pay off the lender? You simply can't, and neither could SVB Bank; hence, it failed. This culminated in a classic run on the bank. This is exactly what happened at SVB.

SVB had an impressive deposit growth, and it catered to tech companies and life science companies. According to S&P Global, 93.9% of its deposits were uninsured by the FDIC because such deposits exceeded the FDIC insurance limits. SVB did not count on retail depositors as its base as it catered to larger companies. Its deposits grew from $65 billion in 2019 to $189 billion in 2022. To earn a return on these deposits, SVB ended up buying long-term US Treasury bonds and mortgage-backed securities which are long duration assets. The problem with this was that when inflation started to increase, the Federal Reserve went on an aggressive path of rate increases. As a result, the value of the securities took a big hit (Bond prices go down if interest rates increase.), and the bank found itself with a gaping hole in its capital structure. The bank tried to raise capital, but word got out that the bank was insolvent. Depositors rushed to move their deposits causing a classic run on the bank.

(713) 572-3366 | (713) 572-8771 Fax
3555 Timmons Lane, Suite 600 | Houston, Texas 77027
www.callahanadvisors.com

Once it was clear that the bank was insolvent, the Federal Reserve, FDIC and the US Treasury department stepped in and bailed out the depositors, even those who had deposits above the FDIC threshold of $250,000. The value of SVB's common stock and debt was marked to zero. The Treasury took this step to prevent panic from spreading to other banks. The United States has over 4,000 banks, and most of these banks are community banks that serve an important purpose of extending credit where the large banks are absent. The last thing the Treasury and the Federal Reserve want to see is the big banks getting bigger.

The SVB saga was a clear failure on the part of the Bank's board, its management, its auditors, and the regulators. Since the bank had less than $250 billion in assets it was not subject to the stricter capital testing under the Dodd-Frank Act. There will be investigations and hearings to get to the bottom of this event.

So how strong is our banking system? Our banking system remains well capitalized and is strong enough to weather the largest economic crisis. The current situation is different from 2008. In 2008 it was mostly credit issues where banks were engaging in sub-prime mortgages, securitizing risky assets and indulging in poor credit behavior such as trading credit default swaps that led to the Great Recession. Another factor that is different from 2008 is that currently interest rates are high which has resulted in a deposit flight from the banks into better yielding short-term products such as US Treasurys and money-market funds. As a result, the banks are being forced to pay up for such deposits, thereby lowering their future earnings as their cost of funds increases. To make matters worse, the SVB saga is also forcing depositors to spread funds across different banks. The management and regulators will have to be ever more vigilant. As the quote above implies liquidity keeps banks alive.

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As always, we are grateful for your partnership and are available to answer your questions.

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