The SVB saga: A simple explainer

Silicon Valley Bank's collapse was brought by a lethal combination of concentration risk, asset-liability mismatch and inadequate lending. Rising interest rates dealt a double blow as they hit the asset book and stalled deposit growth.

DEVINA MEHRA | MARCH 15, 2023 / 09:39 AM IST

The SVB saga also started with many of its depositors asking for their money back or basically in today's world withdrawing or transferring it elsewhere.

About a fortnight ago, only a few of us would have heard of Silicon Valley Bank (SVB) but now, of course, anyone with even a nodding acquaintance with economics and markets knows about it.

The questions I get asked often these days are: What really happened with SVB? How did US regulators react and why? Does it have any implications for the Fed interest-rate trajectory and monetary policy, and hence for the markets around the world?

I will try to explain it in very simple language with no tables, graphs, charts and as little jargon as possible.

First, let us go back to the beginning or rather the beginning of the end which brings me to a lesson I learnt literally at my mother's knee.

I remember my mother explaining a bank run to me when I was in school (For context, she's a postgraduate in economics). That while a bank promises to give you the money you have deposited on demand, in actual fact no bank can pay back its depositors all at once.

The money given by depositors is tied up elsewhere and hence banking is a confidence game.

Even the most solid bank in the world will collapse if all depositors or a large chunk of them line up at the door asking for their money back.

The SVB saga also started with many of its depositors asking for their money back or basically in today's world withdrawing or transferring it elsewhere. The perils of online banking when deposits can disappear in the blink of an eyelid!

Balance-sheet issues

But was SVB a solid bank to start with?

There were actually a few issues with its balance sheet.

One, while many banking crises start with too much poor lending, a part of SVB's problem was that it actually lent out too little. The way we broadly understand the banking business is that the bank takes deposits and other liabilities and then lends out a substantial part of these to create loans and similar assets.

Of course, assets can be things other than credit or loans as well. The most common example being bonds. In SVB's case, it did not do much of the banking credit function and instead channelled most of its deposits into investments.

Two, there was a considerable asset-liability mismatch (ALM). What this complicated sounding phrase means is that while the bank had deposits which were short-term in nature the assets it was buying were long-duration securities. Of course, all banks do it to some extent but in the case of SVB, it was very pronounced.

Concentration risk

It was the basic violation of what is banking 101 i.e. something a trainee in a bank learns. But just as in many other fields of human endeavour the basics are forgotten over a period of time.

Three, it ran a concentration risk with most of the deposits coming from Venture Capital (VC) funded startups and crypto companies. There was no recognition of the fact that even though the company accounts were separate, many of them were effectively controlled by a handful of venture capital firms and the book was a lot more concentrated than it appeared.

In the end, it accelerated the run on the bank as certain VC firms told their investee companies to move their deposits elsewhere as they felt the bank was becoming risky.

Lightly regulated

Four, SVB was not as highly regulated as larger banks like Citigroup, JP Morgan, etc. The regulatory oversight is lighter for banks with assets below $250 billion and SVB assiduously always kept its assets slightly below this level to escape regulation.

The logic for lighter regulation was that these banks were not systemically important but that sure turned out to be untrue!

So this was the setting of the stage. But no one looks closely enough either inside the bank or outside to identify these risks and the bank was getting voted as one of the best banks in the US till weeks before the crisis.

And as we now discover the bank did not even have a Chief Risk Officer for the last few months!

In some ways, the crisis had been building up for it for some time behind the scenes. Interest rates had been rising in the US at a very rapid pace – they are now up 4.5 percentage points in less than a year from near-zero levels.

Rising interest rates

The last time interest rates rose so rapidly in the US was in 1980/81 – coincidentally or not before SVB was founded in 1983.

The rising interest rates hurt SVB in two ways. One, as explained above, SVB had lent out too little and invested mostly in securities, especially mortgage-backed securities (MBS) where the prices fell as interest rates rose and the MBS market is not as liquid as the market for treasuries, so getting out of the positions was not easy.

Plus as these were relatively long-duration or long-tenure securities, their prices fell more than those of short-term securities – that is the way the bond pricing math works.

Two, as money became more expensive it was more difficult for its depositor companies to have 'liquidity events' which is what fundraising of various kinds from venture capital funding to IPO to raising money via SPACs, etc, is called in the Valley.

Therefore, it was a double whammy for SVB when its asset book lost money and its deposit growth also begin to dry up.

This is somewhat different from how traditional banks work where the assets which are in the nature of loans or other credit get repriced upwards, meaning their interest rates increase almost immediately. On the other hand, deposit rates increase very slowly. Hence, for most banks margins go up, at least in the beginning, when interest rates rise.

Deposit rates lag

As an aside, most banks in the US still continue with the very low deposit rates that were prevailing a year ago and have been very slow to increase these.

Of course, much of this is with the benefit of hindsight as even bankers who recognise risk in the system rarely step back from a business that is presumably doing well 'for now'.

As the then CEO of Citigroup, Chuck Prince said in the context of the 2008 crisis, “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance.”

Of course, SVB could have managed things somewhat better as even though the market for MBS is not as liquid as that for treasuries, they could have raised money against the book if they had recognised the problem in advance. This, in itself, was not difficult to do as the Fed's tightening stance has been clear for the last few quarters.

The SVB collapse is also another occasion to remember this golden quote: "There can be few fields of human endeavour in which history counts for so little as in the world of finance," by John Kenneth Galbraith in his excellent book, 'A Short History of Financial Euphoria'.

Lessons forgotten

Lessons from history in finance are easily forgotten and institutional memories are also notoriously short.

As a friend who was working in a large international bank that largely side-stepped the great financial crisis of 2008-9 said that mostly what saved the bank was the memory of one of the senior management team members who vividly remembered the Asian crisis of a decade ago when he was barricaded all night in the bank's branch in an Asian capital while people were screaming for the heads of bankers outside. That reminded him and hence the bank of how bad things could get. Else, risk blindness and failure of imagination are the biggest issues in risk management.

What have US regulators done? Up till now each deposit of less than $250,000 was insured under the FDIC. Now, this limit has been removed and therefore all depositors of SVB as well as other banks in distress will get their money back in full.

Thus the issue has now been contained with the US regulators ensuring that all depositors for SVB as well as other banks are covered in full wherever the issue is erosion in the bond and securities portfolio because of interest rate changes. This doesn't cover credit related issues but that doesn't appear to be a widespread problem, at least as of now.

Creating moral hazard

Of course, in the longer term, it may create what is called a moral hazard, which is bankers or other players taking undue risks because they know that in case things go south, they will be bailed out.

How much this impact will be is debatable as even in the case of SVB the shareholders will be wiped out and unsecured bondholders will also likely take a hit. But, of course, the management has got away with their compensation, including bonuses, intact.

The indirect impact on markets will be if this changes the Fed's stance on rate hikes and tightening. The market has moved very rapidly on that with two-year yields down 60 basis points (0.6 percentage points) in a single day, which is higher than even what happened during Black Monday in 1987.

Now several Wall Street firms are assuming that the Fed will not increase rates in March at all. The terminal rate, which is the rate at which the Fed will stop hiking, has fallen by 0.6-0.7 percentage points.

All eyes on Fed

My personal view is that this is a little overdone as the Fed cannot signal that it is completely taken its eye off the inflation ball. Especially as labour markets have been extremely tight and we have seen only a scattered reduction in inflation.

While things cannot be said with certainty, our base case is still a 25 basis-point increase by the Fed rate this month.

But no matter how things go, a single crisis in a bank has definitely changed the outlook for both bond and equity markets. As they say for politics, just one week has turned out to be a long one in economics and markets.

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