Silicon Valley Bank

I had a recent conversation with a fund manager and we both agreed it was remarkable that interest rates had been raised at unprecedented rates, fastest in history, yet nothing in the economy had broken.

Well last week something broke!

The story, although involving banks and insolvency, is not a repeat of 2008 with lots of crazy complicated loans and crazier valuations. It's rather a story of doing basically the right thing but just not quite, and the 'not quite' bit being all it took in extreme times to fail.

So, Silicon Valley bank (SVB) is what it says on the tin, the bank for technology companies in California. It has boomed in size especially in the last 3 years alongside tech, its deposits up 300% in this time alone.

Now the way banks make money is to create a net interest margin (profit) by borrowing short-term, paying a low rate of interest then lending long term at a much higher rate. That's their profit, the NIM.

In 2020, 2021 and into 2022 the bank was receiving an avalanche of deposits and interest rates were almost zero. So, and this is the fatal decision, SVB decided to invest them in longer duration assets. Not the usual 3-6-month treasuries but 5–10-year treasuries instead.

Why? Because they figured rates would stay low and the longer duration gave them a higher yield increasing their profits, and what could possibly go wrong?

This made sense if you looked at 15 years previously of very low rates. For this strategy to fail the only thing was for rates to rocket higher quickly and that just wasn't going to happen.

Why would this be bad? Because if rates go up the capital value of fixed interest securities like Treasuries or Gilts have to fall. The capital value decreases to push up the yield equal to new treasuries being issued with higher yields.

Now even after this happened it didn't actually mean that the bank had made an accounting loss. Treasuries when they mature pay back the purchase price, so banks are allowed to designate such investments as 'not for sale' and therefore register no loss. But equally and this is crucial, the bank was sitting on assets which if they did sell would be worth way less than they'd paid. So, a whopping deficit did exist.

How does this cause the bank to go insolvent?

Well, you are the banker to the Tech bros, and they are super smart, and they talk to each other. You need one significant Valley player (Peter Thiel) to tell his companies to withdraw all their funds and for it to become public knowledge as to why. His reason being that he'd done the maths and SVB didn't have the money to pay everyone back if they needed to sell the "Not For Sale" bond portfolio because the losses were greater than its cash liquidity. This was true, but equally banks really never have enough money available to pay everyone back if they all ask at the same time. It's a confidence game if people don't worry and therefore don't ask then everything is fine.

If they do, then you get a good old fashioned bank run.

The added element for SVB is that its clients are very connected to social media so word spread super quickly. They all bank remotely so can withdraw funds over the internet instantly and the average account balance is not hundreds or thousands but millions of dollars.

So, the demise of SVB was idiosyncratic but like any bank failure there then exists the potential for contagion and a loss of confidence causing new banks to experience similar runs.

This was dealt with by the US FDIC on Sunday which guaranteed deposits at banks and removed the reason to believe they were not safe. Additionally, they guaranteed everyone at SVB would get their money back in full. So, end of story you would think. Monday was a calm day with markets up strongly.

Well, not quite.

Europe has some terrible banks and the one most determined it seems to implode is Credit Suisse which regularly reports yet another reversal of already tragically impaired fortunes. It said it had started to experience large scale withdrawals as the rumour mill speculated on its soundness. So, banking crisis back on for Tuesday. As of this morning (Thursday) the Swiss National Bank has said it’s giving them €50 Billion to tide them over so banking crisis off again.

One silver lining to this last week of angst is that central banks will now think much harder about additional rate rises. They have now properly broken something in the economy and that’s historically the time they understand they need to stop.