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Silicon Valley Bank Run

On Wednesday, Silicon Valley Bank was a well-respected institution that catered to elite clientele. By Friday, they were shut down. What happened, and should we be worried?

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Silicon Valley Bank (SVB) dominated headlines this week. What was one of the most prestigious banks in the country on Wednesday was effectively shut down by Friday. Investors are spooked for good reason, but before we estimate the probability of another full-blown crisis, let's first explain what happened and why.

The short version is SVB…

1. Favored a niche clientele rather than a diversified client base.
2. Bought interest-rate-sensitive bonds with its clients' deposits.
3. Watched interest rates rise at the fastest pace in four decades.
4. Got hit with a wave of withdrawals as its clients' businesses started to weaken.
5. Sold bonds for a loss so big that they couldn't make depositors whole.
6. Tried to raise capital because they didn't have a "lender of last resort."
7. Told its clients to "not panic."
8. Caused their clients to panic.
9. Ignited a bank run.
10. Failed.

Now, let's unpack it all.

Traditional banks take deposits from people who have money and make loans to people who need money. The difference between the price paid for deposits and the interest rate on a loan is how banks make money. If a bank sells a mortgage for 5% and pays depositors 1%, the bank's profit is 4% (5% - 1% = 4%) of the loan amount.

Banks also "borrow short and lend long." For example, checking accounts allow customers to withdraw as much as they want, whenever they want. But loans like mortgages can last several years, so banks must manage this mismatch.

SVB was anything but traditional. They catered primarily to Silicon Valley start-ups (hence its name), and this clientele is unique compared to most corporate banking clients. For years, these companies were swimming in cash from early-stage investors and profitable business models fueled by low interest rates. But customers with lots of cash also don't need loans, and this created an imbalance for SVB.

SVB had to do something with all this cash, or else it had no way to make money. One option would be to buy 6-month Treasury bonds. These yield 5.32% today[1], while the average savings account pays 0.23%[2]. Meaning, for every $1 billion in deposits, the bank could earn around $51 million annually with zero risk of default. SVB had over $175 billion in deposits, which could theoretically generate $8.9 billion in revenue annually.

But not too long ago, these bonds paid almost nothing. That same 6-month Treasury bond on January 1st, 2022, yielded 0.19%[1]. Even if deposit rates were at zero, $1 billion would have only generated $1.9 million in annual revenue.

That's not enough to operate a large bank like SVB, so they turned to higher-yielding bonds instead. To be clear, these were still risk-free, or at the minimum, extremely safe. But to earn an attractive yield, SVB bought longer-dated bonds measured in years rather than months.

The further out the maturity date of a bond, the more sensitive it is to rising interest rates. No big deal if the intent is to hold to maturity. But SVB didn't have that luxury because they bought these bonds using their clients' deposits. Now, if one or two clients come asking for their money back, again, no big deal. Sell some of the bonds at a loss, give the money back, and move on with life.

But several clients were hit hard as interest rates rose at the fastest pace in four decades. They needed money to pay salaries, etc., and asked SVB for their money back. That was a huge problem because the book value of those bonds was lower than what SVB paid for them (higher rates = lower prices). Meaning, the bank couldn't pay it all back.

Traditional banks are very careful about how they manage their "loan book." For example, if a bank lent 80% of its deposits to oil drillers and energy prices crashed, it could have a serious problem. For this reason, most banks do periodic reviews to ensure they don't loan too much money to one entity or industry. But SVB was niche.

Furthermore, when a traditional bank is short on funds, they borrow from other banks or directly from the Federal Reserve. This system is very well-managed and highly regulated to ensure that the bank runs experienced during the Great Depression don't happen again.

But SVB was not regulated like most other large banks. Hence, they were not privy to the same perks as a J.P. Morgan, so their only other option was to raise money to pay back their depositors. They tried that on Thursday by announcing a stock sale to "plug the hole," or raise enough money to meet withdrawals that could not be serviced by selling their bond portfolio.

On paper, this should work fine. You're short some money, so you go raise capital and get back to business. This happens all the time in Corporate America, but in the banking world, even the faintest sign of weakness can spark panic because the government only insures the first $250,000 per account. Anything above this number is subject to loss, and given most of SVB's clientele held deposits at multiples of this threshold, a bank run ensued (it also didn't help that SVB's CEO told the world to "stay calm" and "not panic" shortly after announcing the stock sale)[3].

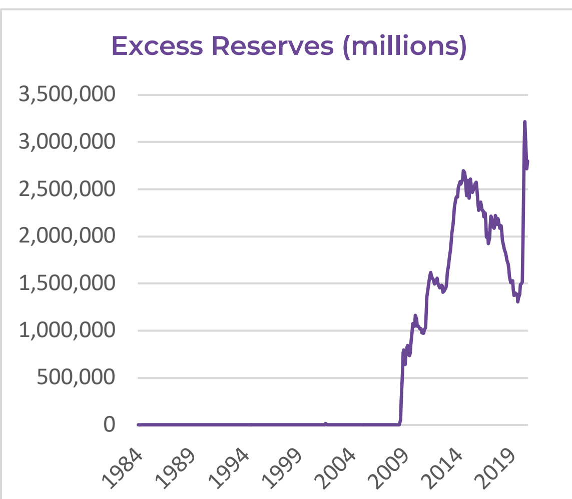
The bottom line

The drama surrounding the demise of SVB has been quick and shocking, but keep five important points in mind before panicking.

First, this is almost certainly an isolated incident. Most large, national banks diversify their deposits, are more regulated, and have less exposure to the investments that hurt SVB. For example, roughly 56% of SVB's deposits were locked up in securities, compared to Bank of America at 28%[4]. It's apples and oranges.

Second, SVB failing is most likely not another "Lehman moment" or any other trigger switch for the next financial crisis. In fact, regulations enacted post-2008 were explicitly designed to prevent a similar crisis. Big banks are now subject to higher capital ratio requirements that prevent them from taking on the risks that took down SVB, and these measures of strength have never been higher.

For example, excess reserves refer to the cash held by a bank above the reserve requirement that an authority sets. These act as a buffer during downturns to protect banks from losses and ensure they have enough money to honor withdrawals. The chart below shows that banks had little to no cushion leading into 2008. Since then, this cushion has grown to trillions.



Source: https://fred.stlouisfed.org/series/EXCSRESNS

Third, unlike SVB, rising interest rates tend to be good for traditional banks because they can charge more for loans while keeping the deposit rate fixed. This increases their spread and profitability. The megabanks also get paid higher interest by the Fed on those excess reserves in the chart above.

Fourth, while the media is having a field day stoking as much fear and panic as possible, banks fail all the time. In fact, it's rare to go a year without a few failures[5].

Bank failures since 2009

Year	Total number of bank failures: 512
2023	1
2022	0
2021	0
2020	4
2019	4
2018	0
2017	8
2016	5
2015	8
2014	18
2013	24
2012	51
2011	92
2010	157
2009	140

Source: Federal Deposit Insurance Corp.

Fifth, our portfolios have no direct exposure to SVB. Regarding small to medium size banks, the average exposure across all strategies to the regional bank sector is approximately 0.03%, with a max of 0.16%. We have historically favored large, national banks that are broadly diversified not just in sources of revenue but also in its loan book, and we see little reason to change this preference anytime soon.

The bottom line is that SVB took on massive risk and paid the price, but the odds that their demise could stoke another financial crisis appear infinitesimally small.

Sincerely,

Mike Sorrentino, CFA

Sources

1 Bloomberg

2 Bankrate.com. As of 3/10/2023

3 https://nypost.com/2023/03/09/silicon-valley-bank-ceo-to-investors-stay-calm-and-dont-panic/

4 https://www.ft.com/content/7cf4eb45-78b7-4e6e-b134-1f0b082ba203

5 https://www.bankrate.com/banking/list-of-failed-banks/

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