# WHAT WENT WRONG?

## Behind the Collapse of SVB and Signature Bank

The markets were broadsided by two of the biggest bank failures in history this week, when regulators stepped in and took control of **Silicon Valley Bank** and **Signature Bank**.

Without warning, two fairly sizeable banks, albeit one concentrated on the venture capital world and the other a crypto-centric institution, got caught in the bear trap of rising interest rates.

The Fed's aggressive attack on inflation, in the form of rapid rate raising evidently caught these institutions by surprise, although regulators have long warned that the end of near-zero interest rates could cause sudden crises in unexpected facets of the global financial industry, as concerns mounted over the impact of rising rates on bank balance sheets

But the intense and rapid decline in the price of Treasury securities held by **SVB**, and many other banks, ignited the crisis. Years and years of free money led to excess deposits, and those deposits, which take longer to lend, were placed in what has always been perceived as safe medium and long duration of Treasuries.

However, the shift to a tighter monetary policy, which included raising interest rates at an unprecedented rate, negatively impacted the value of those securities beyond the comprehension of many money managers, most of whom have never experienced this kind of market, last seen in over 40 years.

Unlike most banks, **SVB** parked nearly 60% of its total assets in its investment portfolio, where the norm is somewhere around 40%.

The strategy had been to categorize these securities as, what has come to be known as *"held-to-maturity"* assets rather than *"available-for-sale"* to allow banks to avoid *"marking to market,"* leading to very large potential write downs relative to book value.

That reeks of the practice of "*GAAP"* accounting loophole, where an institution could book profits all in one year, while writing down losses over an extended period of time going forward, a practice that along with a blessing from the now defunct **Federal Savings and Loan Insurance Corporation (FSLIC)** were allowed to invest deposits in highly illiquid, longer term riskier assets, led to the Savings & Loan crisis of the 80s, another era of free money, though the industry was also riddled with fraud, something that may come to light in regard to **SVB**.

There are reports that insiders sold hundreds of thousands of dollars' worth of shares before the bank collapsed. The CEO reportedly sold 3.6m shares just two weeks before the collapse.

In the case of **SVB**, those excess deposits tended to dwindle more rapidly than other institutions since the majority of its depositors were fledgling tech startups that burn through piles of cash during their formidable years and need to draw down on their cash balances to keep their businesses afloat since equity markets, of late, have been all but closed to raising new capital.

That presented the bank with a mismatch of long-term assets versus short-term liabilities, which should have raised red flags, had their holdings been categorized, or recategorized, correctly.

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In the case of **Signature Bank**, it was more a matter of guilt by association, as the banks clientele, apprehensive by the sudden collapse of **SVB**, withdrew more than $10bln in deposits last Friday, prompting regulators to take over the bank to stave off a bank run and, more importantly insure the stability of the entire banking system.

While, according to a regulatory filing, the institution had assets of $110.36bln and deposits of $88.59blnat the end of 2022, regulators decided to err on the side of caution and stem the tide of deterioration of banking institutions with higher than normal exposure to crypto and tech startups and high levels of uninsured deposits – those greater than $250k - like **Signature Bank**, **SVB** and **Silvergate**, which failed earlier in the week.

The bank created a 24/7 payments network for crypto clients and had $16.5bln in deposits from digital-asset-related customers. To that end, some, including board member, former US. Rep. Barney Frank, see the government seizure as a very-strong anti-crypto message.

Another bank that had been under pressure, **First Republic**, a San Francisco-based bank that relies primarily on private banking, private business banking and private wealth management, narrowly escaped a takeover after declaring that it had more than $70bln in untapped funding from the Fed and JPMorgan Chase.

The consternation surrounding the collapse of **Silicon Valley Bank** and **Signature Bank** appears to have been somewhat abated by the actions taken by the Treasury Department and the Fed to backstop *"all"* deposits, including those in excess of the $250k FDIC insurance coverage.

The risk of a widespread lack of confidence was too great for regulators to not step in. And apparently it worked. Fears have been calmed, **SVB** and **SBNY** are reorganized in an orderly fashion, and depositors are being made whole.

Had regulators not stepped in, the possibility of intervention on a mass scale could have resulted in the massive creation of new money, which is in itself inflationary, while also causing in a severe recession due to an erosion in consumer confidence and hiring.

Either way, the Fed's interest rate policy could be impacted with less inclination to raise rates in these uncertain times.

Regulators had no choice but to step in and backstop all deposits, including those in excess of the $250k FDIC insurance. *"The risk of a cascading crisis of confidence was too great, particularly in the age of social media which was not as influential during the 2008 crisis,"* offered one market strategist.

However, for those of you old enough to remember, the fact that all **SVB** and **Signature Bank** depositors are going to be protected, implies that *ALL* depositors *EVERYWHERE* are going to be protected, means little.

Think back to **Bear Stearns**. Think back to **Washington Mutual**, both were *"rescued,"* until it came to **Lehman** who was *NOT*, and allowed to fall by the wayside.

At least, for now, it appears the markets are not anticipating a **Lehman Brothers** scenario. Nor is the Fed. If they were, they would have already cut rates. Instead, the Fed knows, at least we hope so, that any further rate hikes could trigger further collapses in the financial and tech industries.

The market strategist added, *"Their goal is to demonstrate that depositors will be made unequivocally whole in these early highly-stressed cases in order to prevent runs on the broader group of remaining banks, even those that do appear to be sufficiently capitalized for the markdowns (e.g. First Republic)."*

Speaking of social media, there are some that believe there's a good chance the run on **SVB** never would have happened had it not been for social media.

According to one report, **SVB** was tweeted about roughly 200k times on Thursday, with several founders and CEOs of tech companies posting they were pulling money from the bank.

By Friday, depositors had tried to withdraw $42bln from the bank before being shut down by regulators and taken over by the FDIC.

*"The rapidity of the crisis and social media has taught us that tech is obsoleting the current regulatory structure, which was built in the 1930s,"* said Tom Vartanian, former general counsel of the **Federal Home Loan Bank Board** during the Savings and Loan crisis of the late 1980s.

*"The whole system needs to be looked at differently in a tech-adroit environment. Whereas the loss of confidence took weeks during the S&L crisis, this took a matter of hours because information, as well as disinformation is now available almost immediately,"* he added.

*"The very people, the founders, who would stand to lose the most from a run on the bank, cut off* their nose *to spite their face by tweeting such messages like 'At this point SVB has hours to arrange an acquisition - as a founder it's your duty to your employees and investors to limit your exposure' or 'As one of probably the few founders to go through a modern bank run, get your money out now,'"* remarked one trader.

Social media aside, one only wishes, how can other banks avoid a similar fate? Some advise setting up so-called *"sweep accounts"* which operate an exchange with other banks that effectively deposits uninsured balances into other banks, thus providing FDIC coverage for all deposits up to certain limits, such as $25m.

Another suggestion is to match your assets (deposits), which are on demand, with liquid, readily cashable liabilities, i.e overnight repo, or T-Bills, not longer-dated securities, whether they are Treasuries or not.

Or maybe, it's time for more regulation of institutions of this nature, to ensure the safety of their depositors and the banking industry as a whole since all banks are apparently not created equal.

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