Cidel
Asset Management

A Note on the Silicon Valley Bank Failure

cidel.com

By Arthur Heinmaa, CFA, Chief Investment Officer

On Friday, the Federal Deposit Insurance Company (FDIC) took control of Silicon Valley Bank's (SVB) assets. The rapid failure of SVB, the 16th largest bank in the U.S., has raised concerns that a repeat of the 2008 banking crisis is about to replay. Our view is that SVB's failure is unique and similar failures are unlikely to spread to the broader banking system. We believe this is a crisis of liquidity for SVB rather than a system-wide problem, akin to an old-fashioned bank run.

As a bank customer, when the teller walks into the safe with your deposit, you feel like your money is safe in the vault. But, no commercial bank in the world just stores cash in a big pile waiting to return it to depositors. Banks keep a portion of their clients' deposits in cash and lend out the rest in the form of loans such as mortgages, business loans, and car loans. They also invest in government bonds. The cornerstone of this structure is that all depositors will not ask for their money back at the same time and therefore, only a portion of the cash is needed to be kept on hand at any point in time. This system is known as fractional reserve banking.

Imagine a bank with only one customer who deposits $10,000,000 into the bank. With only one customer, there is always a risk that they may withdraw their money in totality. So, that bank must be able to access cash immediately and should only invest in liquid treasury bills. The bank would earn a very small spread, but it manages its risk by matching assets and liabilities.

Now, consider a bank that has $10,000 of deposits from each of its 1,000 clients. The bank has the same total deposits, but now has a diverse client base. So, the likelihood of all 1,000 clients pulling out their money at the same time is very low. In this case, the bank can invest depositors' money in loans or bonds to increase their earnings. To manage the gap between the deposits (short term) and loans (long term), the bank may entice depositors to lock in their deposits through term deposits. The bank's risk management activities are centred around managing this gap, ensuring it does not pose undue risk to the bank's capital structure. The bank earns an enhanced return, while keeping client money safe.

To make sure that banks are following this process, the bank regulators scrutinize deposits, investments and compliance processes to ensure that a bank should not fail. In the aftermath of the 2008 financial crisis, regulators' focus was not only on the solvency of each bank but the risk to the entire financial system (macroprudential policies). Banking regulators in every developed country work to ensure that their citizens have confidence in their financial systems. For the past 15 years, bank failures have been infrequent and relatively small.

Now, let's look at what we know about SVB. SVB had a concentrated client base with large deposits from many technology firms in California. Evidently, they had a big vulnerability to large withdrawals from their client base. For years, their deposits grew as technology firms raised money from investors but, in 2022, these firms were no longer raising money and instead, withdrawing cash to meet payroll. Herein lies the problem; SVB mismatched the maturity of their investments with the characteristics of their deposit base. Essentially, they had a large carry trade – borrow short term and invest long term. As interest rates rose, the value of their bond portfolio dropped, and it seemed that they didn't manage their risk correctly. As the losses and gap grew, they did nothing. When clients starting withdrawing money, they simply couldn't satisfy the requests.

So, where were the regulators? The irony is that, in 2015, Greg Becker, President of SVB, lobbied Congress against imposing extra regulations on his firm. He told Congress that "enhanced prudential standards should be lifted, given the low risk profile of our activities". He was successful and regulatory oversight of regional banks was curtailed. Regulators are tasked with ensuring that depositors will not lose their money. In this case, the lack of regulator scrutiny contributed to the collapse of SVB.

Cidel
Asset Management

A Note on the Silicon Valley Bank Failure

cidel.com

In 2008, every bank had similar depositors and invested in the same asset class. As real estate prices collapsed, all loans were under water and depositors wanted their cash. Today, other banks have broader deposit bases and are not linked to one single strategy. In addition, the banking system is better capitalized, and the large systemically important banks (SIB) are subject to much more regulatory oversight.

In 1991, the Bank of New England experienced a similar bank run. At the time, it was the 3rd largest bank failure in U.S. history and markets were fixated on the implications of its demise. Today, few remember the bankruptcy. It is likely that the consequences of the demise of SVB will be absorbed by markets and will similarly be forgotten over time. However, in the short run, markets will continue to be influenced by news surrounding SVB. The expected turmoil has historically provided opportunities for disciplined investors. We believe that it will be no different this time. This is not to say that the markets will not be volatile, but we believe the banking system is not at risk.

*Cidel is an operating name of Cidel Asset Management Inc.

March 2023

This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The information contained in this document has been compiled by Cidel Asset Management Inc. from sources believed to be reliable, but no representations or warranty, express or implied, are made by Cidel Asset Management Inc. as to its accuracy, completeness or correctness. The opinions expressed are as of the date of this publication and may change without notice and are provided in good faith, but without legal responsibility. Cidel Asset Management Inc., carrying on business as Cidel ("Cidel" is a registered trademark) is registered as a portfolio manager, investment fund manager and exempt market dealer in Ontario. Cidel is also registered as a portfolio manager and exempt market dealer in the provinces of Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland and Labrador, Nova Scotia, Prince Edward Island and Saskatchewan. In Quebec, Cidel is registered as a portfolio manager, investment fund manager and exempt market dealer. This document may not be reproduced, distributed or published by any recipient hereof for any purpose.