The Thinking Man's Approach

March 2023 | Series #97
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- SVB failed because of internal risk management oversights, an erosion in depositor confidence, and regulatory failure
- The Fed has established an emergency lending fund to protect depositors, while a number of alternative liquidity measures have helped to calm fears of contagion
- In spite of the recent bout of stress, the broader banking system remains on firm footing
- Larger banks with the benefits of more stringent protocols and scale will outperform, while many regional banks will be forced to consolidate or be acquired
- We are now feeling the consequences of swift monetary tightening after a period of prolonged loosening. Monetary policy is a blunt tool, which more often than not results in unforeseen accidents

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Thoughts on the 2023 Regional Banking Crisis

"I regard it as very unfair, but capitalism without failure is like religion without hell."
— Charlie Munger

In this edition of our Thinking Man we will provide our thoughts on the collapse of Silicon Valley Bank, and the ongoing stress affecting the global banking sector. Though the situation remains highly fluid, there are already important lessons to be learned and new implications to consider.

Silicon Valley Bank: a poster child of a badly run and regulated bank

Silicon Valley Bank ("SVB" or the "Bank") was established in 1983 to serve mostly unbanked tech start-ups that had been historically ignored by traditional banks. SVB branded itself as a "one-stop shop" for the venture-backed world: providing debt financing, corporate banking and wealth management services to tech entrepreneurs, while "speaking the language" of the tech community.

And yet, however helpful the bank might have been in cultivating innovation, it also engaged in a number of less-than-best practices. For starters, it often made it a condition of many of its loans, that the borrower park all of its cash at SVB (as opposed to spreading it across several banks). This resulted in more than 90% of SVB deposits being above the $250k FDIC insurance limit – increasing the probability and risk of a panic-induced bank run. Most alarmingly, the Bank's internal risk management department suffered from frequent reorganizations, was often understaffed, and relied on outside parties to advise on its asset-liability matching. The Bank's internal oversight repeatedly failed to keep up with the fast pace of growth in its balance sheet. For a period of 8 months, the Bank did not have a dedicated risk officer; and for what it's worth, SVB's Chief Administrative Officer, Joseph Gentile, was the CFO of Lehman Brothers leading up to its collapse. Even though the Bank was at the heart of the tech scene, its own internal technology systems were often "creaky" according to a Wall Street Journal article citing internal sources.

Ultimately, it was this lack of risk management, combined with high deposit concentration, that brought the Bank down. Over the course of the pandemic, the Bank saw massive deposit inflows which it put to work in longer-dated U.S. Treasuries and mortgage-backed securities. As the Fed began to increase rates, these longer duration securities were the most affected, resulting in large unrealized losses. SVB's mistake was not only in buying these long-dated securities in a world where the Fed was aggressively raising rates, but also in failing to see how the concentration of its deposit base could lead to volatility in the liabilities side of its balance sheet (i.e. deposits). To make matters worse, the Bank had also let expire a number of interest-rate hedges which would have protected the Treasury portfolio from losses. Tighter financial conditions eventually caused many start-ups to withdraw cash, prompting outflows, and forcing SVB to realize losses on its securities portfolio.

On March 2nd, Moody's notified the Bank that it was considering downgrading the Bank's rating, which prompted the Bank to shore up its financial position by attempting to issue $2 billion in new equity. Concerned about what the issuance reflected about the financial position of the Bank, Peter Thiel and other prominent venture capitalists moved to withdraw their deposits, resulting in $42 billion in outflows over the course of a single day. On March 10th, SVB shares were halted, state regulators took possession of the Bank, and the FDIC was appointed receiver.

What is alarming about this whole episode, is not only SVB's internal risk management failures, but also the failure of the regulatory system designed to prevent these outcomes. Part of the responsibility lies with the rolling-back of certain Dodd-Frank provisions in 2018. Particularly relevant in this case is the raising of the threshold for stress testing and living wills (i.e. a document which lays out the procedures for ensuring the orderly dissolution of a bank) from $50bn to $250bn. Under these changes SVB was not subjected to the same level of scrutiny as larger institutions. Additionally, records show that going back to last year, the Federal Reserve had issued MRIA ("Matter Requiring Immediate Attention") warnings to SVB about certain risk management shortcomings, but ultimately failed to follow through on requiring the Bank take action to remedy the issues. Lastly, it is worth nothing that the asset-liability mismatch on SVB's balance sheet was partly a product of policy actions taken by its own regulator: the Fed. If the regulator was aware of the impact that its own policies could have on weaker banks, perhaps it should have been more deliberate in mandating regulatory improvements.

Thoughts on the broader financial system

As of this writing, the Federal Reserve (in conjunction with federal and state regulators) have taken measures to support the stability of the financial system. SVB's deposits (that are in excess of the $250k FDIC insurance limit) have been backstopped through a new emergency lending facility. Additionally, a consortium of U.S. banks have agreed to go as far as helping a competitor, by making an uninsured deposit of $30bn in First Republic Bank. Across the pond, UBS has agreed to purchase Credit Suisse in order to stem fears of global financial contagion.

Our current view is that, for the time being, the global financial system remains on solid footing, and that the current crisis will be adequately contained. Unlike the 2008 crisis there does not appear to be a cataclysmic category of the credit market that could lead to systemic distress. Though higher interest rates and tighter financial conditions will inevitably lead to a continued increase in defaults (particularly commercial real estate loans and over-levered private assets), the banking system, overall, is well equipped to deal with stress. G-SIB's (Global Systemically Important Banks) are better capitalized, better regulated, have more diverse revenue streams, and better risk management than in 2008. Though many large banks do have large unrealized losses on their balance sheets (as a result of holding long-duration government issued securities during a period of rising rates), their deposit bases are more stable and their underwriting standards are more stringent. If worse comes to worse, we believe that the Fed and Treasury have already demonstrated a commitment to being the lender of last resort should a situation of unmanageable stress emerge.

Nonetheless, we do believe that the current moment represents the beginning of an important shift within the financial sector: large banks will buy smaller banks, and smaller banks will merge with each other. In a digitized world, banking relationships at a retail level have changed. It is no longer necessary to meet your local banker at a coffee shop to haggle over a mortgage rate, when you can easily compare competing rates on a single platform. Indeed the entire banking relationship, particularly for younger generations, depends much less on human relationships than in the past. The U.S. currently has more than 4,000 banks in operation, many of which simply lack the scale to compete with the larger players, or to appropriately diversify their loan books. A higher cost of capital will mean even lower margins for smaller banks. The only solution will be further consolidation. Though concentration might be bad for competition, perhaps it is a worthy cost to pay for ensuring that every bank can appropriately manage and control the risks on its balance sheet.

Though we are confident about the prospects of high quality banks like JP Morgan and Goldman Sachs (though these banks are not without their own misadventures), we are less confident about the regional banking sector which is very much still not out of the woods. Putting aside operating performance and risk management, the banking business is ultimately a business that depends on trusts between counterparties. The current bout of uncertainty has shaken regional banking to its core. Indeed the nature of bank runs is often mostly self-fulfilling, precisely because of this psychological element to the banking relationship. There will be winners and there will be losers, ultimately determined by relative scale, reputation, underwriting discipline, and trust.

Where we go from here

We are now living the consequences of the unwinding of the quantitative easing (QE) regime, where for more than a decade, cheap money encouraged excessive risk taking (i.e. SPACs, meme stocks, crypto, and sky high valuations across low quality assets). It turns out that you simply can't run the most reckless monetary and fiscal experiment in history without the bill eventually coming due. The first invoice arrived as stubborn inflation; the second arrived as a surprise financial panic. History has repeatedly taught us that monetary policy is a rather blunt tool which lacks the finesse to avoid financial "accidents" like the one we are now living.

The challenge now facing the Fed is how to maintain credibility in its inflation-fighting mission, while also having to inject liquidity to ensure the proper functioning of the banking system. Perhaps the solution may come in increasingly unorthodox measures (like ensuring *all* deposits at *every* bank, or working with banks to get them to deposit funds in each other). At any rate, the Fed must keep as its first priority the taming of inflation. At the same time, given that banking stress is likely to further tighten financial conditions, the probability of a recession is now, no doubt higher than it was at the beginning of the year. As recession probabilities increase, so too does the probability of lower inflation and lower rates. The focus then must shift to how deteriorating operating performance affects credit worthiness and earnings potential. In any scenario, we continue to believe that a cautious stance across all asset classes is warranted, as we will continue to see an environment of high volatility and uncertainty at least through the first half of the year.

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