# Weekly Market Flash

## Bad Banks and Bad Bankers

***March 17, 2023***

Just one week ago, we were sitting here writing about the latest jobs and inflation numbers, figuring that those were the only open items left for the Fed to consider ahead of its March 22 meeting on monetary policy. How quaint that seems now, in hindsight. Around the same time, in the middle of the day last Friday, the news broke that the sixteenth-largest bank in the country, Silicon Valley Bank, was being taken over by federal regulators in the wake of a massive run on the bank by angst-ridden depositors.

Fast forward to today, and there has been a veritable fire hose of events and moving pieces that has complicated the picture of economic health, the soundness of the global banking system and, yes, what the Fed should do when the Federal Open Market Committee meets next week. Let's try to pin down some of the many crisscrossing stories and see if we can find a common thread.

### Burning Down the House

We'll start with the story that launched all the subsequent craziness. The first thing we should emphasize is that the Silicon Valley Bank saga is not, as far as any of the evidence to date suggests, the tip of an iceberg of systemic risk throughout the banking system. A bank that catered almost exclusively to the Silicon Valley ecosystem of tech start-ups, venture capitalists and their ilk had grown fat on deposits from the industry's mountains of cash generated during the latest boom cycle that peaked in 2021.

Not knowing what else to do with all the deposit money pouring in from their customers, the bank invested billions of dollars into US Treasury and mortgage-backed securities – a seemingly safe move except that it happened at the peak of the market when interest rates were near zero. When the Fed began its interest rate increases last year the value of those securities fell accordingly. For reasons that seem unfathomable to us, SVB's executives sat by and did nothing while the Fed kept raising rates and their assets kept falling in value. At the same time – and largely for the same reason of rising rates – the fortunes of their customers in tech land were fading fast. As these customers made withdrawals to fund their companies' operations, the pace of new money coming in slowed to a trickle, putting the bank's liquidity coverage into question.

Even with the increasing shakiness of SVB's financial soundness, though, the bank could have arguably muddled through had it not been for the ability of a few prominent Silicon Valley influencers – mostly the venture capitalists whose portfolio of start-ups were the lifeblood of SVB's customer base – to incite the financial equivalent of a panicked mob rush to the exits of a burning building. In just one day, a week ago Thursday, $42 billion worth of deposits bum-rushed out the door. Enter the regulators, and goodbye to the beating heart of Silicon Valley's financial microsystem.

### End of the Road for Crypto Banks

We tell the story of Silicon Valley Bank in order to emphasize the unique combination of factors responsible for its demise. This fact is in stark contrast to the root causes of the 2008 financial crisis. Then, the problem was systemic because almost all the major players were exposed, to one degree or another, to the same toxic assets (and highly leveraged to boot). SVB's business model, asset mix and customer base profile were in no way widely replicated throughout the system.

Unfortunately, though, the timing of SVB's demise coincided with other problems revealing themselves in the banking system. One day before all those tech bros stampeded out of SVB a bank with a similar-sounding name but a very different business model had folded. This was Silvergate, a bank that styled itself as a gateway between the starched-shirt world of traditional banking and the Wild West of cryptocurrencies. Whatever that means in actuality, Silvergate wound down its operations on March 8. A few days later another crypto-centric bank, Signature Bank of New York, was revealed to have failed and was taken over by federal regulators.

Last Sunday afternoon – a few hours before financial markets in Asia were due to open – a team of US government representatives from the Treasury Department, the Fed and the FDIC announced that all depositors in Silicon Valley Bank and Signature Bank – not just those with deposits of $250,000 or less but all depositors – would be made whole. Now things were getting strange, and unsettling. If these two banks, each with its own particular story of misery and without evidence of some kind of systemic linkage, were being treated the same way by the regulators, what else might be out there that could go wrong?

## Another Country Heard From

While investors tried to digest what all this meant for the US banking system, yet another tale of woe hit the tape. This one came, of all places, from the august banking capital of Zurich, Switzerland. Credit Suisse, which along with its peer rival UBS has sat atop the world of bespoke finance for the wealthiest of the ultra-wealthy for many decades, had been on a slow burn for many months. Myriad problems including lax risk and compliance controls, shoddy financial reporting and a major data breach had been public knowledge since at least last fall. But this week Credit Suisse shot back into the headlines when its biggest investor, the Saudi National Bank, announced that it would not be providing any further assistance to the bank beyond the 9.8 percent equity stake it already had.

Credit Suisse is plugged into the global financial system in a way that neither Silicon Valley Bank nor the crypto twins of Silvergate and Signature Bank ever were. Was this, then, the signal that the problem was, in fact, systemic? No. But there was already a bad enough vibe coursing through the financial bloodstream that the Swiss central bank deemed it appropriate to step in with a $54 billion liquidity facility to shore up confidence among investors and depositors. The bank remains solvent, but its future is cloudy.

## What Are The Common Threads?

There are still more banking stories out there. A consortium of major US banks put together a rescue plan yesterday for First Republic Bank, a west coast institution with a large base of high net worth investors that had come under fire in the wake of the SVB failure. Other smaller regional banks have seen a wave of deposit outflows as customers head for the perceived safety of the largest institutions, or avoid banks entirely and plonk their cash in money market funds. And banks' use of the Fed's discount window, which tends to be used as a last-resort liquidity backstop, surged to a record high of $152 billion this week.

Do we still maintain that this is not a systemic problem? Yes. But that does not mean that there are no common threads connecting these stories. We see two linkages that stand out.

The first common thread is bankers behaving badly. As we described earlier, Silicon Valley Bank's executive team seemed to go through the entirety of 2022 with blinders on, willfully ignoring the direction of interest rates even while, FOMC meeting after FOMC meeting, Jay Powell kept saying the same thing about "higher for longer." SVB ran itself more like a risk-hungry investment bank than a staid, prudent

manager of other people's money. As for the crypto banks – well, if your business model is based on an asset that still cannot plausibly demonstrate that it has a credible use case outside of black market business on the Internet, then that sort of speaks for itself. And poor management at Credit Suisse, as we noted above, has been evident now for a very long time.

Tolstoy wrote in "Anna Karenina" that every unhappy family is unhappy for its own particular reasons. The same can be said about banks in the current environment: every tale of misery has its own unique story of how things turned south.

That might not be so bad except for the other common thread between these stories: trigger-finger depositors. Are there deep-seated problems at all the regional banks where customers have been pulling out their money this week? Most likely not. But finance, as we all know, is based on confidence. And human emotions, as we also know very well, are highly vulnerable to the lizard brain instincts of fear and greed. One bank's bad management can become a system-wide problem if confidence is not restored.

That's why we have both government regulators and private consortia (like the team of banks that put together the rescue package for First Republic). The measures taken so far are, we believe, appropriate for the situation at hand. These measures suggest to us that both the regulators and the other systemically critical banks – the likes of JPMorgan Chase and BankAmerica – see the situation similar to how we see the situation; i.e. a few stories of poor management by bad bankers and a need for a liquidity backstop to calm the frayed limbic brains of angst-y depositors.

The other part of the story, of course, is what all this means for the broader economy and for the Fed's decision on interest rates next week. We could spend a whole other commentary just on this – and it is very likely we will do just that next Friday, in the wake of the FOMC meeting next Wednesday. For now, though, we will note that the European Central Bank went ahead this week with the 0.5 percent increase in rates that had been expected before all the banking news broke. That, to us, was the right thing to do. As the ECB noted in its post-meeting communique, inflation is still "too high" and the fight to bring it down needs to continue. The central bank's decision should also be good for the message it sends about confidence that the banking system can continue to function soundly even as central banks continue to fight inflation. We expect to hear similar sentiments from Jay Powell next week.

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