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THE SYSTEMIC RELEVANCE ONE WOULDN'T SUSPECT

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The collapse of Silicon Valley Bank (SVB) left the market divided between those in fear of further contagion risks and those blaming the failure on a mix of interest rate hikes and loose regulation. The latter may appear ironic as banks had been blaming low interest rates for over two decades and lobbied for easing the regulatory stranglehold ever since. However, something must be wrong if a default of that size can happen as unexpectedly as this one. We asked **Dr. Alpay Soytürk, Chief Regulatory Officer at Spectrum Markets,** what went – or still is – wrong.

Alpay, let's first look into the business activities of SVB and to what extent this business model was unique

As the 'Silicon Valley' in its name suggests, SVB specialised in the financing and servicing of the early-stage borrowers in the Bay Area's vibrant tech sector when it started 40 years ago. At the time, most established banks refused to work with borrowers from the new technology industry and venture capital funding, though not unheard of, was nowhere near as it is today in terms of volume and relevance. From a standard bank's perspective, this was an unexplored, high-risk area. Silicon Valley Bank started in 1983 as a state bank and member of the Federal Reserve[1], simultaneously registering with the SEC[2], planning to take up public equity capital directly from the start. It was definitely a risky strategy then, but the uniqueness rather lies in the 'community' approach the bank applied. The founders of SVB were seeking solidarity with the founders of the tech companies that were supposed to become SVB investors first, then their clients. In case this approach worked out, these entrepreneurs would be loyal founding partners, lucrative clients and very effective multipliers in a tight-knit, sometimes sworn fellowship of young company-owners.

Was it this community approach that finally sealed the bank's fate?

The answer is a clear yes in two ways, even if neither is immediately obvious. The first thing one would associate the bank's failure with is probably its loan exposure towards young technology companies. However, this sector's credit risk was not and had in fact never been a cause of concern or losses for the bank. The monoculture on the liability side of SVB's balance sheet, by contrast, had been a concern before. As the various forms of private equity financing of start-up companies started picking up speed, the deposits of technology companies, inherently high anyway, grew even more. In 2015, SVB's loan-to-deposit ratio was slightly above 40% - for comparison, the aggregate loan-to-deposit (LDP) ratio of the Eurozone's significant institutions[3] was 105%[4] in 2022. The deposit overhang was problem earlier though. As you learn as an economics or finance freshman, while a too high LDP ratio means an increased likelihood of a bank being unable to cover potential loan losses, a ratio that is too low indicates the bank acts below an adequate degree of profitability. In order to put the excess funding to work, SVB started to engage in the real estate sector, with limited success.

As a consequence, and with deposits having become entirely free funding for the bank in the context of ultra-low fed funds rates, SVB invested strongly in investment-grade assets of the highest quality such as U.S. treasuries. If you want to incur a yield here, you must engage at the very long end of the curve, which SVB did. Another basic economic lesson is that while the interest rate of a bond rises, its price will fall, i.e., the increase in interest income will come at the expense of lower valuations of the relevant bond in your books. At the same time, if you want to keep deposits in times of rising interest rates, you'll have to pay interest on them as well. Here's where the club approach caught SVB twice. On the one hand, the focus on the narrow group of entrepreneur clients turned out to be huge problem in light of a clouded environment for start-up financing with those clients seeing their bank deposits depleting in order to keep liquidity in their own companies up. On the other hand, a broader, more diversified depositor base would have meant a much lower dynamism of the withdrawal process in response to the bank's inability to pay higher deposit rates.

As SVB itself said on 8 March, it had to sell virtually its entire AFS[5] portfolio, worth $21bn. According to an FFIEC[6] filing, this position stood at $26bn as of 31 December 2022. At the end of the day on which SVB reported the fire sale of its AFS bonds and that this incurred it a loss of $1.8bn, the company shares had lost 60% of their value. By the end of the following day, SVB clients had withdrawn $42bn of deposits as a DFPI[7] report shows. On 10 March, regulators shut down the institution to stop the run on the remaining deposits. So, in the case of SVB, a handful of large clients withdrawing their money had been enough to infect the handful of other clients also pulling back in bank-run style. And as we have learnt from crises of financial institutions in the past, no bank, however strong and well-capitalised, will survive a bank-run.

That ultimately raises the question of the role of supervisory authorities and whether loose regulation played a role

There is a lively debate going on in the U.S. as to whether existing bank regulation goes far enough, whether smaller banks should come under more scrutiny and about the impact of bank deregulation under the Trump administration. It is true that SVB was granted a 5-year deferral from the so-called Volcker Rule in 2017, restricting banks from using deposits for entering into proprietary trading activities and from owning or investing in a hedge fund or private equity fund – an exemption the former government extended to all banks.

While this step has been absolutely questionable and the discussion around reversing it is necessary, it misses the point here. As discussed, though attributable to poor risk management, SVB's problems did not stem from poor asset quality. Stressing your interest bearing position by subjecting it to simulated basis point shifts is one of the most basic scenario analyses undertaken in liquidity risk management. There is nothing sophisticated in determining the impact of rising or falling rates on your interest income and there was plenty of time to realise the turning point would come for central banks to enter into a rate-hike cycle.

How do you rate the systemic relevance of SVB?

I believe that there is an obvious misconception when referring to systemic relevance. If you look at the Eurozone, we have a clear regime for determining a bank's systemic relevance based upon an institution's size, economic importance, its cross-border activities or whether it has requested or received funding from the ESM[8] or the EFSF[9]. A bank can also be considered significant if it is one of the three most significant banks in a Eurozone country. Plus, the ECB reserves the right to classify a bank as significant at any time to ensure that the relevant supervisory standards are applied consistently. And it is no surprise that the political debate in the U.S. over whether to lower the significance thresholds for systemic institutions is in full swing.

The misconception, in my view, is that the potential spill-over effects from a bank's failure are not necessarily, or not exclusively, connected with its systemic relevance. As the example of SVB shows, while neither the bank's size, nor its interconnectedness should give rise to the fear that the financial system is in serious trouble. Nevertheless, media reports suggest that the world is on the brink of the next global financial meltdown. Just to remind you, the deposits – those that haven't been withdrawn – are still there and the bank's assets haven't become worthless either. So, it's entirely irrational to initiate a run on this bank because Silvergate[10] has filed for bankruptcy – a small bank, totally irrelevant systemically, closely tied to the valuation of cryptocurrencies and without any relevant links to SVB.

Coming back to the regulation discussion, a tight regulatory regime and, more importantly, a strong supervisory enforcement regime, are inevitable for the functioning of the financial system as a whole. And it is fair to say that if interest rate risk has become a systemically important issue to monitor, then this must be on the agenda of authorities. However, the fact that most consumers have developed a better sense for abstract economic relationships than a community of start-up investors, is not least the result of the regulatory progress made over the last decades. Furthermore, it reveals a kind of risk that must be referred to as idiosyncratic. The last few years have seen a trend towards some type of 'start-up investor smartness' that is at times retrospectively transfiguring a bet that paid off into a strategy, calling out loud for crypto deregulation and removing all the barriers standing between them and their fortune. Regulation, however, is in place to protect the retail investor and to ensure the stability and resilience of the financial system. It should not back off from individual megalomania, whether it wears a pinstripe suit or flip-flops.

Thank you very much!

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[1] U.S. Central Bank System
[2] U.S. Securities and Exchange Commission
[3] Banks that the ECB considers 'significant' due to and which it supervises directly
[4]
[5] Available for sale (balance sheet category)
[6] Federal Financial Examination Council
[7]
[8] European Stability Mechanism
[9] European Financial Stability Facility
[10] Silvergate Bank was a Californian bank providing services for cryptocurrency users which went insolvent following the fall in cryptocurrency prices and the bankruptcy of crypto exchange FTX

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