ALPHA SOURCES

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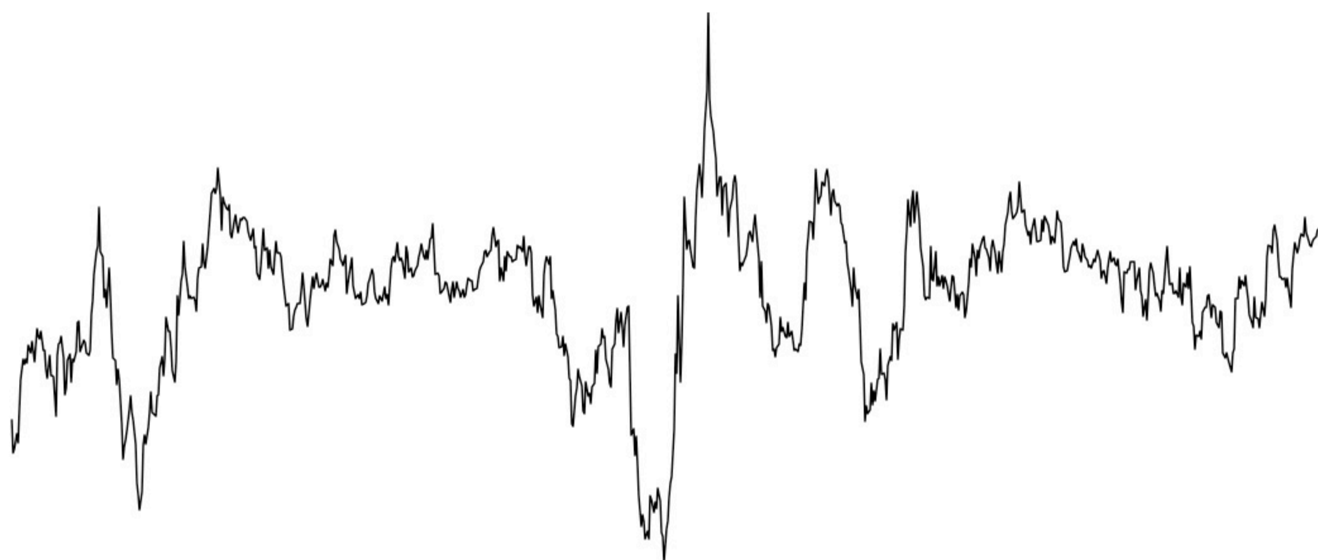

SYSTEMIC?

The big news in the past week in financial markets is the accident report on the demise of Silicon Valley Bank—SIVB—which was put into receivership by US regulators on Friday. This was a very quick death spiral. At the beginning of the week, the stock was trading at a cool 280 bucks, and now my assumption is that the equity is zero. You'll read many versions of this story this week, but I'll try to sketch the stuff that everyone seems to to agree on. I will then highlight some of the areas where analysts and commentators disagree, and where there should be scope to make, or lose, money.

IT'S A RUN!

In a nutshell, SIVB was ended by the nemesis of all banks; a run on its deposits. An initial capital raising effort to stem the flow, as well as presumably panicked efforts to persuade some

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of the banks' biggest depositors to keep their money in the bank, failed. On Friday, The California Department of Financial Protection and Innovation shut down the bank, replacing it with a new institution, the National Bank of Santa Clara, which has taken over the assets and liabilities of the now defunct SIVB. The next steps are fairly simple. Insured depositors will be made whole first, and completely. Uninsured deposits likely will get a dividend, though in the case of the largest depositors it's possible that haircuts will have to be taken. Creditors will then be standing cap-in-hand, in front of equity holders. At this point, the sources I have read suggest that neither will walk away with anything, but time will tell.

WHY DID SVB DEPOSITORS RUN FOR THE EXITS?

The Net Interest Substack, authored by Marc Rubinstein, has a great round-up of the events, and internal decisions at SIVB, which contributed to the bank's end. Christoper Whalen adds important perspectives here, as well as in a recent Forward Guidance podcast, here. Finally, John Cochrane chimes in here. The elevator pitch goes something like this. SIVB was banker for large swathes of the US tech scene. This means that it held and took deposits primarily from US tech firms, and venture-capitalists supporting and investing in tech firms. As any commercial bank, it took in deposits and invested chunks of this money in long-duration, and ostensibly 'zero-risk assets', mainly treasuries and mortgage backed securities. Then came the Fed's aggressive interest rate cycle, which put a strain on the bank from two sides. Firstly, the inflow of deposits slowed, and in the case of some big accounts, reversed as low-interest fueled boon in tech VC financing and start-ups slowed. Sec-

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ondly, and crucially, losses on the bank's securities portfolio swelled in response to the Fed's interest rate hikes. This was the case in the context of the bank's mark-to-market portfolio, as well as its unrealised losses in its non-mark-to-market portfolio. Ultimately, attempts to sell assets, from the non-MTM portfolion, to meet deposit demand failed. This is because the loss incurred to sell these assets meant that the bank had to raise more capital, which it failed to to. And as depositors grew ever more fearful that these losses would prevent the bank from honouring deposit requests, the inevitable happened.

IDIOSYNCRATIC OR SYSTEMIC?

So far, I've only stated what seems to be relatively trivial and widely agreed facts, so let's get down to business. People in the know generally emphasise two idiosyncratic factors, which contributed to SIVBs end; this is to say, two reasons why this is *not* a systemic event. First, SIVB's had a very concentrated deposit base, which made it particularly prone to a deposit run due to the correlated nature of the demand for liquidity among its key clients. The risk of a word-of-mouth driven run also increases with a concentrated deposit base. Secondly, SIVB's asset management in response to higher interest rate was sub-optimal. For example, the bank had a larger share of MBS than its peer group, as per Christopher Whalen, leaving it more bruised from the Fed's hiking cycle than other banks.

What's the problem then? SIVB had a concentrated deposit base, prone to large outflows, which was toxically correlated to the decline in value of the very mis-managed assets, whose sale the bank would rely on to meet deposits.

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Unfortunately, it might not be that easy. SIVB possibly isn't the only bank where unrealised losses on its bond portfolio excee its net equity position. Crucially, other banks might get a cash call from the regulator if they need to sell assets in a hurry. Surely SIVB is not the only bank sitting on a significantly worsened funding position, given how inverted the yield curve is, and it isn't the only bank whose capital ratio, *including* unrealised losses on long duration assets, looks worse for wear.

I think Christopher Whalen is absolutely right when he says that;

"What is now the most sought-after list on Wall Street by short-sellers? The list of banks with above-peer holdings of MBS."

I would add banks "who would struggle to sell assets to meet deposits without a capital raise" to this list, bearing in mind that it was exactly this failed capital raise, as per Marc Rubinstein, which sent SIVB into the arms of the regulator. John Cocrane , linked above, has some very interesting charts on this. Rumours suggest that vultures are now circling First National Republic Bank. It will be one to watch at the open today.

WHY DIDN'T AUTHORITIES STEP IN?

There are two reasons why authorities will refrain from stepping in to save a financial institution circling the drain. First, the system will let a bank fail if it believes that it is a non-systemic institution, or secondly because it believes that stepping in would lead to moral hazard.

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In most cases, watching from the sidelines will be motivated by a combination of the two. Time will tell whether the Fed and US treasury has made the correct decision here. I am a bit surprised that the Fed didn't attempt a rescue via a funding operation in which it would accept collateral, in this case MBS and treasuries, in exchange for short-term lending. There is ample precedence for this as a crisis-busting tool, especially in Europe during the sovereign debt crisis where the ECB offered EZ banks liquidity for all kinds of ostensibly impaired duration assets. As such, there is an element of the dreaded doom-loop in SIVB's demise, since what exactly should the bank have invested its liquidity in, if not the best quality long duration assets issued by Uncle Sam himself?

The macro-rationale for *not* offering such liquidity is the same reason the ECB is now happy to watch TLTROs evaporate. Put differently, providing liquidity to banks at attractive funding rates can, in the extreme, impair the monetary policy transmission mechanism, when policy rates are rising. But this is also circular-reasoning. If the Fed's interest rate policy is now increasing the risk of bank runs in parts of the US banking system, doesn't the tell us that the hiking cycle is beginning to cause unintended damage? The answer to this question really depends on whether you think SIVB's end is either non-systemic, or fair discpline metered out by the need to make money scarcer in the face of too high inflation. I have a sense that we will be a lot closer to an answer to this question at the end of this week. In the meantime, it's time for investors in bank equities to brace themselves. Opportunities will be plenty, but pick your horses carefully. Good luck!

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