Funding the Future

Why the Silicon Valley Bank failed and the lessons to b...

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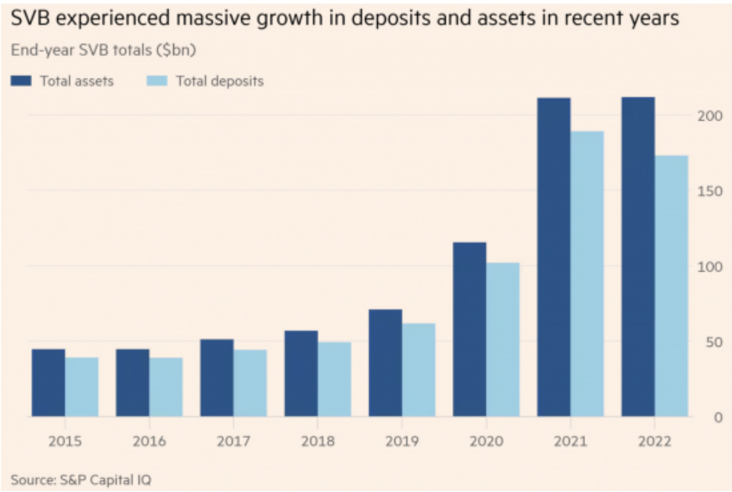
The US-incorporated Silicon Valley Bank (SVB) failed last Friday. It is not clear what the extent of the failure might be as yet: suggestions are that it is insolvent to the tune of many tens of billions of dollars, but this might exaggerate the issue. What seems certain is that it cannot meet the banker's promise of payment on demand when sums are due and that means it is bust.

The bank failed for a straightforward reason. Although it claimed to be a tech bank it actually was little more than a cash deposit taker in reality. During the Covid era the size of the bank grew massively, largely by taking more deposits, as this chart from the FT showed:



The trouble for this bank (and some others, as it is not the only US bank failure this weekend) is that no one wanted the money being deposited with it. The loans they made in comparison to deposits were small. Instead they had to find another use for the money in order to pay interest to depositors.

To do that they bought what seemed like valuable bonds (mainly but nit entirely US government ones), which paid interest that appeared above average at the time in proportion to value. By doing so they increased the apparent rate of return they made by about 0.4% compared to the return they could have made by placing funds on deposit with other banks.

However, interest rates then rose, and it seems that SVB had never planned for that possibility. As a result they had not considered the consequences for them of this eventuality.

If the Silicon Valley Bank had placed money on deposit it wotld not be bust now. It would still have that money. It would even be making good money on its funds. But it had bought bonds and when interest rates rise the value of bonds fall because the actual interest paid on them is fixed and therefore the only way in which the effective interest rate on them can be increased is by their price falling.

It is not clear by how much the bond portfolio of the Silicon Valley Bank has fallen in value, but it may be, as already noted, by tens of billings of dollars. This was no problem if depositors appreciated that this was only a paper loss that would only give rise to a real cash cost if the bonds had to be sold. Last week that hope fell apart. Depositors asked for $42bn of money from SVB last week. The Silicon Valley Bank could not find it. An attempt to raise new share capital was unsuccessful. Insufficient bonds could be sold. Those that could be were loss making. The bank was bust.

Rumour has it that HSBC will take over the UK operation of SVB this morning.

In the US the government has guarantee all depositor’s money using the fund it has created to underpin its deposit guarantee scheme even though many of the deposits in question far exceed the $250,000 that scheme guarantees.

It seems likely that the UK government is trying to guarantee something similar here.

So, what are the lessons?

The first, and most obvious is that these bankers clearly had no clue as to what they were doing. Yet again the so-called ‘masters of the universe’ have got things wrong.

Second, regulation failed. The risks in this bank were obviously incorrectly appraised by them, and it was allowed to continue trading when there was obviously too much risk implicit in an apparently well funded balance sheet.

Thrd,the bank had insufficient capital for the risks it took. If there had bern sufficient capital it would not now be bust.

Fourth, as ever, this bank presumed the state would cover its risk. As ever that has proved to be correct. The mockery of privately owned banks continues when what they actually do is extract value for private gain safe in the knowledge that governments will not let them fail.

Fifth, the fallout from the over-inflation of interest rates by the Fed is clear. These are being artificially manipulated upward when there is no need for that, most especially when there is no US wages spiral. Artificial risk is being created instead by over deflating asset prices too quickly for markets to handle. This crisis was created by the Fed.

Sixth, this bank was used by the well off and the companies they own. There is always an excuse for bailing them out. None is found for anyone else. Wealth flows upwards, as ever.

Seventh, cash deposits served no economic purpose here: most of what this bank did added no economic value. Despite that it will secure an expensive bail out. At some time we will realise that savings do not equate to investment, and the models we have for saving make no economic sense, as this failure proves. But we are not there yet.

Eighth, this is market failure because this bank could not even manage cash, the most basic task asked of it. It was said to be reality good at tech. Based on this are we really expected to believe that? Surely we can do better than this?

In summary, it seems this bank failed because it did not even understand cash management. I hope no state funds are involved in its bail out.