SVB collapse exposes deep problems in US financial system

Nick Beams
15 March 2023

In the wake of the collapse of the Silicon Valley Bank (SVB) on Friday, the second-largest bank failure in US history, followed by the takeover of the New York-based Signature Bank by the Federal Deposit Insurance Corporation (FDIC) on Sunday, the third largest, questions are being raised about the stability of the entire US financial and banking system.

There was a certain irony in the demise of Signature. One of its board members was Barney Frank, a former House of Representatives member and co-sponsor of the Dodd-Frank legislation, which was enacted in the wake of the 2008 financial crisis and was supposed to prevent a repetition of such events.

As a result of SVB's demise, depositors withdrew $10 billion from Signature, leading to its being taken over. "We had no indication of problems until we got a deposit run late Friday, which was purely contagion from SVB," Frank told the business channel CNBC.

The Fed and the FDIC, with the full backing of the Biden administration, which has pledged to do "whatever is needed," have justified their actions—full coverage for wealthy uninsured depositors at SVB as well as increased liquidity provisions for banks—on the grounds of "systemic risk."

If that is the case, then it means that all the regulations and measures introduced after the 2008 crash, embodied chiefly in the Dodd-Frank Act, are not worth the paper they are written on.

There are divergences in financial markets over what has been done.

Ken Griffin, the founder of the hedge fund Citadel and a strident advocate of "free markets," told the *Financial Times* that the rescue of uninsured depositors should not have taken place.

"The US is supposed to be a capitalist economy, and that's breaking down before our eyes," he said. The losses to depositors would have been minimal and would have "driven home the point that risk management is essential."

Others have a completely opposed position, including prominent hedge fund manager Bill Ackman. Ackman called for a major intervention, tweeting that "our economy will not function effectively without our community and regional banking system."

During the meetings between the Fed, the FDIC and US Treasury Secretary Janet Yellen, venture capitalists, who formed much of the client base of SVB, intervened heavily and played the military card.

One anonymous source involved in the lobbying campaign, cited by the *Financial Times* (FT), said the theme of their pitch was "this is not a bank."

"This is the innovation economy. This is the US versus China. You can't kill these innovative companies."

The SVB crash was triggered by two interconnected processes set into motion by the Fed's interest rate rises over the past year, as it seeks to batter down the wages upsurge of the working class in response to the highest inflation rate in four decades.

The tech sector, especially in the most speculative areas involving the financing of start-ups by venture capital firms, has been heavily affected by the drying up of the flow of money into new projects. This led to money which had previously poured into SVB, one of the main conduits for this process, being withdrawn.

SVB had invested the money it received in 2020 and 2021, when the Fed was providing money virtually for free, into Treasury bonds and mortgage-backed securities. However, the interest rate hikes have meant that the market value of these financial assets has fallen below their book value, and SVB made losses when it came to sell them to meet the cash outflow.

When a move by SVB to strengthen its capital base with a new share issue failed, the FDIC intervened.

There is no doubt that SVB's dependence on Treasury bonds and its failure to hedge its operations—apparently in the belief, held by other sections of the market as well, that the Fed would have to start to cut rates in the not-too-distant future—was a significant factor in its collapse.

But the SVB case, notwithstanding its peculiarities, has thrown the spotlight on other banks whose position has worsened with the decline in the value of their holdings of Treasury bonds.

According to research undertaken by economists from five major universities and reported on by the FT under the headline “The US bank system is more fragile than you’d think,” the problems that hit SVB are present on a wide scale.

The study found that with the rise in interest rates, “the US banking system’s market value of assets is $2 trillion lower than suggested by their book value of assets.”

It said a case study of the SVB failure was illustrative because “10 percent of banks have larger unrecognised losses larger than those at SVB. Nor was SVB the worst capitalised bank, with 10 percent having a lower capitalisation than SVB.”

It noted that: “Even if only half of uninsured depositors decide to withdraw, almost 190 banks are at a potential risk of impairment to insured depositors, with potentially $300 billion of insured deposits at risk. If uninsured deposit withdrawals cause even small fire sales, substantially more banks are at risk.

“Overall, these calculations suggest that recent declines in bank asset values very significantly increased the fragility of the US banking system to uninsured depositor runs.”

SVB has been described as something of an outlier because of its heavy dependence on government bonds and mortgage-backed securities which it did not hedge for a loss of value.

But those issues notwithstanding, the study reported on a major change.

“Prior to the recent asset declines all US banks had positive bank capitalisation. However, after the recent decrease in value of bank assets, 2,315 banks accounting for $11 trillion of aggregate assets have negative capitalisation.”

This means that the final balance of what they owe is greater than the capital stock of the company, meaning that the risk of insolvency increased.

Government bonds are not the only asset being hit by the interest rate rises. Real estate, particularly commercial real estate, where the effects are compounded by reduced demand for office space because of the COVID pandemic and the increase in working from home, is also a potential source of turbulence.

An article by Robert Burgess, the executive editor of Bloomberg Opinion, published yesterday, drew attention to real estate as a source of vulnerability for banks, with commercial real estate loans making up close to 24 percent of all their loans.

“If market participants are wringing their hands over the potential fallout from the collapse of Silicon Valley Bank, just wait until they look at the banking industry’s exposure to the rapidly weakening commercial real estate sector,” he wrote.

According to Burgess, it seemed as if every day brought news of some big property going into default, noting that in the past weeks “an office landlord ... defaulted on about $1.7 billion mortgage notes on seven buildings in San Francisco, Boston and New York.”

The ongoing fallout from the SVB collapse has both political and financial policy consequences.

On the political front it has completely exposed the Biden administration as the bagman for the wealthy, the super-rich and financial speculators, prepared to dole out money, in whatever quantity necessary, to protect their interests.

It has major consequences on the monetary policy front with the Fed, due to meet next week. Before the SVB collapse, it was considered likely that in view of what the Fed continually refers to as the “very tight labour market” it would revert to an increase in its interest rate of 50 basis points, after dropping to a 25-basis point rise in February.

Now the betting in the markets is that a 25-basis point rise is the maximum, with some predictions that it will make no rise at all. And longer-term policy is completely up in the air. The central policy of the Fed has been to keep raising rates, in the name of “fighting inflation.” But this objective, as the SVB collapse has so graphically revealed, threatens to set off a major financial crisis.