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Lessons from the collapse of Silicon Valley Bank

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*The collapse of Silicon Valley Bank shows that banks still pose risks. Are they systemic? **Jón Danielsson**, **Robert Macrae**, and **Nikola Tchouparov** write that while it is unlikely that the failure of SVB will lead to a crisis, it shows us that the financial system is much more fragile than the public had been led to believe.*

The collapse of Silicon Valley Bank, SVB, sent shockwaves through the financial system, reviving memories of the global crisis in 2008. SVB failed because of mistakes made by the bank, the financial authorities, and the bank's clients. We were assured that bank management and regulators had risk under control after the global crisis in 2008, but here is another large bank failure. Is SVB an outlier or the canary in the coal mine and the first of many?

SVB failed for one of the oldest reasons why banks fail. It raised funds from demand deposits, investing them into longer-term assets, creating a classic liquidity mismatch. That is what all banks do, and it is the job of the banks' risk managers and the regulators to minimise the danger created by such a mismatch.

The danger plays out when the bank's clients all wish to take their money out of the bank at the same time — a classic bank run. This process is, of course, familiar from the global financial crisis, not the least the Northern Rock bank run in October 2007. Behind the fancy facade, depositors never really know how safe their money is, and when fear starts to spread, depositors run to get their money out.

SVB had grown extraordinarily fast, with total assets almost doubling from $116 billion at the end of 2021 to $216 billion at the end of 2022, making it the 16th largest bank in the US and the second largest bank failure in US history.

SVB appeared to play it safe by investing deposits into US government bonds, a type of investment without much credit risk since it seems unlikely the US government will default on its obligations. The US regulators considered these bonds to be perfectly safe. After all, governments like to tell banks to treat their own sovereign debt as risk-free for credit purposes. Even when the Greek government defaulted a decade ago, the European regulators insisted banks consider Greek government bonds risk-free. One reason is that this lowers the interest rates on new government bonds and helps the government financially.

The risk SVB faced was not default but rising interest rates. It bought its bonds in a world where interest rates had been very low for quite some time. The US central bank, the Federal Reserve, set these low interest rate levels with the best intentions to stimulate the economy and recover from the global crisis in 2008. It was not alone in doing so. Central banks worldwide, including here in the UK, did the same. Unfortunately, in the process, the central banks did not sufficiently appreciate new types of risk created by the low interest policy. As firms adapted to the low interest rates, they eventually became dependent on low interest rates so that they would face significant difficulties when the rates increased, something that was inevitable.

When the Fed raised interest rates sharply to fight inflation, the value of SVB's bonds fell. Surprisingly, nobody appeared very concerned. SVB management could have reduced positions and realised losses but chose to buy even more bonds. Regulators permitted this. SVB depositors are mostly wealthy tech companies, venture capital firms and their management teams, that had ample opportunity to accurately assess the risk facing SVB from its regular accounting disclosures.

It is, therefore, particularly galling that the tech companies here in the UK that were banking with the London branch of SVB were calling for a government bailout. Very wealthy individuals demanded bailouts, so the government would have to reallocate from social programmes such as the NHS to their bank accounts. What is especially concerning is the careless language the Chancellor of the Exchequer used on bailing out SVB, considering the social impact of government financial policy in the crisis in 2008 and how this fuelled populist rhetoric.

Fortunately, not many other banks have the same particular vulnerabilities as SVB. It had a narrow deposit base and invested most of its assets into government bonds. However, despite SVB's unique characteristics, its failure reminds us that the financial system is more fragile than we would like. The financial authorities promised us after 2008 that there would not be a repeat, financial regulations would protect us, and there would be no bailouts. Yet here we are in 2023, with the US government bailing out SVB depositors, the UK government feeling obliged to underwrite a sale of SVB's UK subsidiary, and a substantial fraction of world banks nursing similar losses on positions in government bonds. This is not a recipe for stability.

The SVB crisis indicates a failure of the post-2008 financial policy, both regulations and monetary policy. Prolonged low interest rates followed by rapidly rising rates gave ample warning that banks with significant exposure to bonds were at risk. However, it appears that management and regulators were not sufficiently concerned until recently.

The financial authorities are in a difficult position. While the fallout from the collapse of SVB has been contained, it also showed how vulnerable many banks are to rising interest rates. The central banks need to keep interest rates high and even increase them to fight inflation, which undermines financial stability. Meanwhile, governments are in a much weaker fiscal position than in 2008, so they have less room to respond to a crisis. The high inflation makes it practically impossible to fight a crisis by printing money like we also did in 2008. Furthermore, while there was little political opposition to bailouts in 2008, that is not the case today, and any bailouts would fuel political extremism.

While it is unlikely that the failure of SVB will lead to a crisis, it shows us that the financial system is much more fragile than the public had been led to believe. The most likely consequence of its failure is that the regulators will tighten their scrutiny of banks, increasing the cost of lending and slowing the economy down.

Ultimately, SVB demonstrates the difficulty of ensuring financial stability by controlling risk. The financial authorities can never find all sources of risk, and we just end up with an increasingly costly and uniform banking system, hurting the economy and increasing systemic risk.

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Notes:

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