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Comments On The Banking Industry
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Turmoil in Banking

Certain subscribers to our Market Commentary have requested a comment on the recent turmoil in the banking industry. In view of the high interest in the topic, we are making this preliminary assessment outside our regular monthly cycle of commentary.

The turmoil began with the collapse of Silicon Valley Bank at the end of last week. SVB was a medium size commercial bank specializing in providing banking services to Silicon Valley's high tech community. At the time of collapse it had a large base of deposits which exceeded the FDIC's insurance threshold of $250,000. Those uninsured deposits would in part be needed to pay mid-month payrolls and significant fear developed that many of the technology industry's firms would be unable to meet payroll and would collapse themselves. Sensibly, over the weekend the FDIC announced that it would honor all deposits and so this disaster was avoided. In part the FDIC was, of course, motivated by a desire not too carve out the heart of the United States's innovation engine. However, another likely consideration is that SVB had good assets and the FDIC is likely to recover all its funds in an orderly liquidation. By contrast, had the FDIC allowed payrolls to go unmet and local firms to have closed, the value of SVB's loan portfolio would have been severely impacted. Thus both consideration of the FDIC's narrow mission as well as public policy concerns supported the favorable treatment of uninsured deposits.

Differences Between 2008 ad 2023

Silicon Valley Bank's failure has touched a raw nerve with the public – reminding them of the banking crisis of 2008. Actually the two crises are very different. The 2008 crisis was driven by a failure to manage credit risk, whereas SVB's woes are a failure to manage interest rate risk.

During the venture capital boom sparked by the pandemic, SVB experienced a huge influx of deposits as Venture Capital Funds and VC funded firms parked liquid reserves at the bank. SVB has been in business for 40 years and has developed plenty of experience with the tech industry's boom-bust cycle. Prudently it did not funnel those new deposits into its loan portfolio, but rather parked the cash in Treasury bonds. Given the shape of the yield curve, it chose to push out into the long end of the curve to pick up spread. In doing so, it took on considerable risk once rates started to rise. For reasons not clear to this author, the bank did a poor job of managing its liabilities. It could have pushed customers in to term deposits that would be a more stable funding base for long treasuries, but it seems not to have done so. In funding long Treasuries with uninsured deposits the bank was setting itself up for a classic implosion. In our market commentary of December 2020 we noted that a bond bear market had begun and we have repeatedly advised that short rates were likely to rise above 5%. We claim no special genius in making this assessment – Silicon Valley Bank's risk officer must have known that a dangerous scenario could be unfolding over a year ago. The bank's examiner also would have been very remiss not to have raised this evident portfolio risk with management. Unfortunately, SVB tried to tough out the interest rate cycle. Instead of putting in place hedges and selling off risky positions incrementally, it moved its long Treasuries into the "hold to maturity" portfolio which did not need to be marked to market. In other words, it swept the problem under the rug rather than dealing with it. However, as new influx of VC funding dried up customers began withdrawing liquid reserves. Ultimately this funding contraction forced a liquidation of assets at a loss. At this point the bank decided to deal with the problem, and it went for a big bath liquidation of its long bond portfolio which put a billion dollar dent in its balance sheet. However, its business franchise was still valuable and its balance sheet remained respectable so the bank expected that it could repair the dent with an orderly raise of public equity. It disclosed its bond liquidation and announced a $2 billion dollar equity issue. The public reaction was unexpected – a public run by uninsured depositors which collapsed the bank in 36 hours.

Causes of Silicon Valley Bank's Collapse

Not all the facts are yet out, but what we appear to be dealing with here is a combination of stupidity and bad luck. The stupidity is in the poor management of interest rate risk. Today managing bank interest rate exposure is practically an exact science and its a little surprising that a bank can still collapse through such an elementary error. However, SVB's business competence was in managing technology sector lending. It was not a money center bank and that in part may account for its errors in judgment. Unfortunately the pandemic boom caused it to outgrow its area of business competence. The bad luck was in misjudging the state of the market. Prior to SVB's collapse it was not clear that the muscle memory of 2008 was still so strong and that depositors would be so prone to panic. Similarly, it would not have been obvious that the capital markets are closed to banks at this moment in the cycle.

Regulatory Response

Regulators have naturally taken note of the events. The inadequacy of limited FDIC insurance to stop bank runs is once again obvious. One solution is to extend insurance coverage to demand deposits of all sizes – a crisis step which was taken in 2008. Since the FDIC finds itself backstopping large deposits after the fact anyway, it might make more sense to back stop them from the start and avoid value destroying bank runs. It is broadly recognized that runs are the worst way to deal with mismanaged banks. So far the regulators have not taken this step. Instead the Federal Reserve has announced a limited loan program which will accept Treasury bonds at par value as collateral. Had this program been available to SVB, it would have avoided the confidence destroying big bath liquidation of its bond portfolio and presumably would have had adequate time to deal with its portfolio problem in an orderly manner. We think the Fed's loan program is itself a stopgap solution which the regulators hope will defuse this particularly problem while they put their heads together and figure out a better long term solution. What that solution should be is not entirely obvious. Unfortunately neither stupidity nor bad luck can be regulated away. Creating rescue mechanisms is beneficial, but it can also create moral hazard. Regulators will be right to be thoughtful in their response.

Are SVB's Problems Widespread in the Industry?

A pressing issue is whether SVB's problems point to systemic problems through out the banking industry. Well certainly many banks will have been motivated to reach for yield during the low yield environment of the epidemic and will have pushed further out in the bond maturity spectrum than usual. However, SVB's problems were compounded from many separate issues:

1. very large deposit inflows which had to be parked
2. followed by steady cumulatively large outflows
3. failure to manage liabilities
4. over reliance on the "hold to maturity" portfolio
5. failure to trade out of the problem incrementally
6. obtuseness about changing sentiment among depositors and capital providers

It is unlikely that this set of circumstances is reproduced through out the industry. Accordingly, we expect losses in long bonds to be a fairly common drag on industry earnings but to be life threatening at only a few institutions. For those banks, the Fed's lending program provides something of a lifeline.

Market Fears

Since SVB's collapse, the market has been in a jumpy state expecting further shoes to drop and looking at every situation with skepticism. Several regional banks have seen heavy share price drops which probably point to ongoing withdrawls by nervous depositors. The Federal Reserve has been actively supporting these lenders and is clearly determined to prevent contagion from the SVB situation taking them down. We expect the Fed will succeed in this crisis intervention. Signature Bank, a medium size New York regional bank has also been forced to close by a bank run. Its particular issue was exposure to the the cryptocurrency industry – again something of a one off situation. Of more importance has been mounting loss of confidence in Credit Suisse. Credit Suisse is a very large systemically important Swiss bank. It is an important underwriter and wealth manager as well as an international commercial bank. Problems at Credit Suisse emerged in March 2021 when it became clear that credit risk controls in its prime brokerage unit were inadequate. Since then problems of management, risk control and accounting controls have emerged in other departments of the bank. These persistent issues point to a large complex institution with either weak or misdirected top management. Such a situation is naturally concerning and the bank's deposit base has been eroding. This is a problem the Swiss National Bank will need to handle. Again, we think think they will avoid a crisis generating collapse.

What We Worry About

These currently hot issues all seem special situations and not systemic factors. There is one potentially systemic issue which does cause us concern, however – lending on commercial real estate. During the pandemic there were two dramatic changes in real estate utilization – work from home and online purchasing replacing in-store purchases. Both dramatically reduced occupancy in office buildings and reduced traffic through malls. As the pandemic has lifted some of the changes in real estate utilization appear to be long lasting and potentially permanent.

In the office market, we think companies have realized that distributed online working is a viable solution. They will encourage hybrid in-office/at home working to reduce their costly real estate footprint. They will also shift away from the "whole staff in one office in a metropolitan center" model to distinct teams/departments distributed among multiple smaller suburban/secondary city office spaces. This is terrible news for commercial landlords and bad news for their lenders. Prior to the pandemic the country was at full employment with a 5% office vacancy rate and rising rents. Today rents in class A buildings are nudging up 1-2% in nominal terms, but are actually falling in inflation adjusted terms. At class B spaces rents are declining even in nominal terms. Vacancy rates in certain large markets are shown in table 1. The national vacancy rate at 16.6% is more than three times the pre-pandemic level. Experience in the major east and west coast markets hews close to the national average, but in the center of the country things are much worse. Texas has a 21% vacancy rate, the Midwest and Mountain states are only slightly better at 18% and 17%. At the individual city level, locations with vacancy rates currently above 19% include Houston(26%), Atlanta (20%), Chicago (19.4%) and Austin (19.1%.) Construction at the national level is expected to increase the office stock by only 2%. But some markets are expanding much more rapidly: Austin (7.6%), Boston (5.4%), Nashville (5.3%) Charlotte (5.2%), San Diego (5%), and Seattle (4.7%) are all expanding at more than twice the national rate. Notably only Boston is among the country'straditional metropolitan centers. Looking at the unabsorbed volume (current vacancy plus space under construction) we see 9 cities above 20%. We think this unabsorbed volume is going to apply considerable pressure on owners of older and less choice properties. The saving grace is that commercial office leases tend to be multi-year and tenants prefer to renegotiate rents rather than move. Credit problems in this sector may appear more as a gnawing problem than as a breaking wave.

We do not probe in the same depth into shopping malls. Malls have been in secular decline for a decade as neighborhood mini-malls have grown in popularity. Mall vacancy rates at 5% are not currently that high, but foot traffic remains 16% below pre-pandemic levels. It seems likely that the decline in malls will continue and possibly accelerate. We would expect to see the deepest declines in locations which have de-emphasized police control of street crime, shoplifting and vandalism. These locations are an odd mix of municipalities with weak economies and reduced revenues and prosperous municipalities with highly progressive politics.

Table 1: Select Markets For Office Space

		Volume (Million Square Feet)				Rate (% Built)	
Region	**City**	**Built**	**Vacant**	**Under Construction**	**Unabsorbed**	**Vacant**	**Unabsorbed**
US	All	6,506	1,080	124	1,204	16.6%	18.5%
East Coast	Boston	239	23	13	36	9.5%	14.9%
East Coast	Manhattan	451	69	10	79	15.4%	17.6%
East Coast	New Jersey	188	32	2	34	17.1%	17.9%
East Coast	Philadelphia	177	25	2	27	14.1%	15.5%
East Coast	Washington DC	386	53	5	58	13.8%	15.1%
East Coast	All	1,441	202	32	234	14.1%	16.3%
West Coast	Bay Area	200	36	6	42	17.9%	20.8%
West Coast	Los Angeles	284	42	3	44	14.7%	15.6%
West Coast	Portland	57	10	1	10	17.3%	18.5%
West Coast	San Diego	92	13	5	18	14.1%	19.1%
West Coast	San Francisco	155	29	7	36	18.8%	23.0%
West Coast	Seattle	137	0	6	7	0.2%	4.9%
West Coast	All	926	130	27	156	14.0%	16.9%
Texas	Austin	88	17	7	24	19.1%	26.7%
Texas	Dallas	274	49	7	56	17.9%	20.6%
Texas	Houston	230	60	4	64	26.0%	27.7%
Texas	All	592	126	18	144	21.2%	24.3%
South East	Atlanta	194	39	4	43	20.0%	22.3%
South East	Charlotte	75	10	4	14	13.2%	18.4%
South East	Miami	71	8	2	11	11.7%	14.8%
South East	Nashville	57	10	3	13	18.0%	23.3%
South East	Orlando	54	9	1	10	16.5%	19.2%
South East	Tampa	63	10	0	11	16.3%	16.9%
South East	All	515	87	15	102	16.8%	19.8%
Midwest	Chicago	300	58	3	61	19.4%	20.3%
Midwest	Twin Cities	113	17	1	18	15.1%	15.7%
Midwest	All	413	75	3	79	18.2%	19.0%
West	Denver	155	28	3	31	18.3%	20.2%
West	Phoenix	138	24	1	24	17.0%	17.6%
West	All	294	52	4	56	17.7%	19.0%

Note: Unabsorbed is currently vacant plus under construction

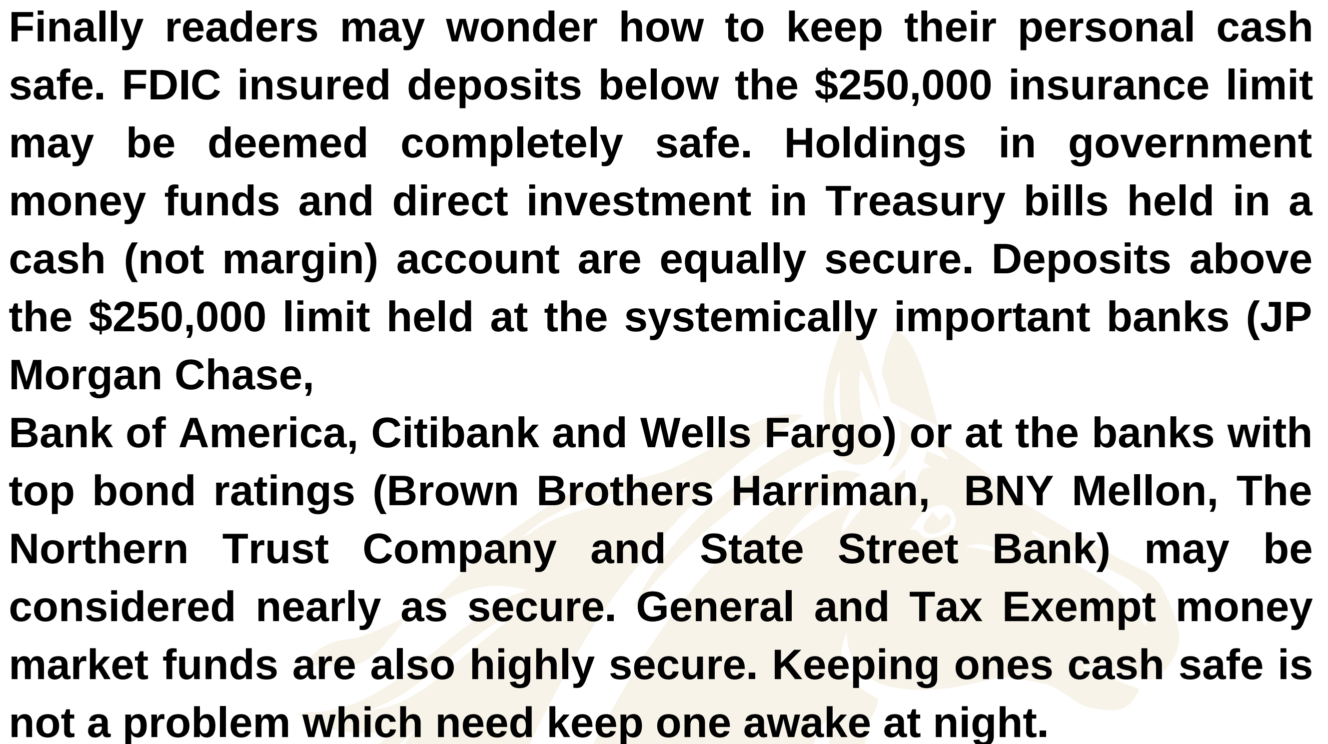
Source: Commercial Edge *National Office Report February 2023*

Impact on the Economy and the Stock Market

In terms of the wider economy the scent of fear in the air will undoubtedly discourage banks from making loans and some borrowers may find it difficult to renew maturing loans. This credit contraction will have much the same effect in slowing the economy as a Federal Reserve interest rate hike. Accordingly, we expect the Federal Reserve to pause its tightening program until it feels the economy has digested this latest event. In the technology industry the near death experience triggered by SVB's collapse is likely to be seared on the minds of top managers. They will be quicker to cut costs and to move cash reserves to fully secure depositories. Venture capitalists also have had a frightening experience and are likely to be even more cautious in backing firms. These are not entirely rational but rather primal fear responses and it will take some months for the shock to dissipate. The stock market has been volatile on the news. This volatility may create opportunities for professional traders, but at this juncture we would not recommend bargain hunting by our clients.

In most business cycles problems show up at banks during the down phase of the cycle. In most cycles these problems are lagging indicators of problems in the general economy. Unless the problems become systemic and drive at least sectorial credit contraction, the bank problems are unlikely to deepen or extend the down cycle. The SVB collapse certainly had the potential to become a sectoral problem, but at this moment it appears that adequate if somewhat late regulatory action has addressed the immediate threat. Unless a more systemic crisis manifests, we do not expect the course of this business cycle to be much effected.

Keeping Cash Safe



Finally readers may wonder how to keep their personal cash safe. FDIC insured deposits below the $250,000 insurance limit may be deemed completely safe. Holdings in government money funds and direct investment in Treasury bills held in a cash (not margin) account are equally secure. Deposits above the $250,000 limit held at the systemically important banks (JP Morgan Chase,
Bank of America, Citibank and Wells Fargo) or at the banks with top bond ratings (Brown Brothers Harriman, BNY Mellon, The Northern Trust Company and State Street Bank) may be considered nearly as secure. General and Tax Exempt money market funds are also highly secure. Keeping ones cash safe is not a problem which need keep one awake at night.