Silicon Valley Bank Flash Commentary

It was certainly a wild weekend.

We've all read by now about Silicon Valley Bank's collapse. These events highlight the dangers of being overly exposed to high-risk, over-extended sectors, and the importance of prudent risk management. In SVB's case, their risk controls fell short when high inflation and the subsequent immediate and dramatic increase in interest rates caused mismatches between their assets and liabilities, as they have for many US financial institutions.

This case of mismatching is best explained by a simplified example. A bank will take in deposits and will secure those with assets. Customers can access their deposits any time so the bank must be prepared to provide customer funds in very short order. However, if the assets backing those funds are longer term (such as 10-year government bonds) then there is a mismatch between the customer's need and the bank's ability to provide. This may not present an issue most of the time (under normal circumstances) as only a small percentage of bank customers are withdrawing at any given time. Issues arise in the case of a bank run, where many depositors withdraw at once.

In times of stress, this is an accident waiting to happen, and the pace of interest rate increases has exacerbated these mismatches. Even though, as in our example above, the assets backing deposits may be government bonds with a guaranteed value at maturity, guaranteed funds in 10 years cannot help a bank cover cash needs now. The bonds could be sold to provide liquidity, but given the increase in interest rates, the current value of those bonds is much lower than the par value. This is the crux of the current situation; the timing of the assets is mismatched with the high demand for current withdrawals, and those assets have unrealized losses and can't be sold on the market at their par value due to the unprecedented rise in rates.

The government has thus far bailed out two banks that were "too big to fail", thereby avoiding a systemic financial meltdown. This is different than what happened during the Great Financial Crisis. At that time taxpayers' money was being used. Shareholders were diluted and bond holders protected. In the case of SVB, all shareholders and bond holders have been wiped out.

The FDIC government insurance fund, capitalized by premiums paid by banks, will absorb any losses. The fund will recoup any losses by assessing more premiums on the banks.

A lot is being written on the subject, and I have nothing to add other than how, in volatile times such as this, having very low risk in your portfolio and being diversified across a number of asset classes is what makes most sense to us. Preserving capital is paramount. There will be more shoes to drop in the coming months.