JSB Capital Management, LLC

Pro-active Wealth Management

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Notwithstanding the sudden collapse of Silicon Valley Bank on Friday (the second largest bank by deposits to fail since Washington Mutual in 2008), the overall banking sector in the U.S. is significantly more stable and well capitalized than they were in 2007-2009. The industry is also subject to a higher level of scrutiny and regulation now.

In addition, the banking sector and financial industry in general back then were flooded with artificial mortgage backed "investments" known as "Collateralized Debt Obligations" (CDOs) that became further metastasized as "CDO Squared" which only held derivatives, not actual mortgages. Those horrible securities blew up and cratered the financial system in what became the "Great Recession." That is far from the case today.

Following the near financial system collapse back in 2008 several initiatives were put in place by banking authorities in an attempt to avoid future systemic calamities by measuring and forecasting the liquidity and asset risk associated with large Systemically Important Banks (SIBs) and large Regional Banks.

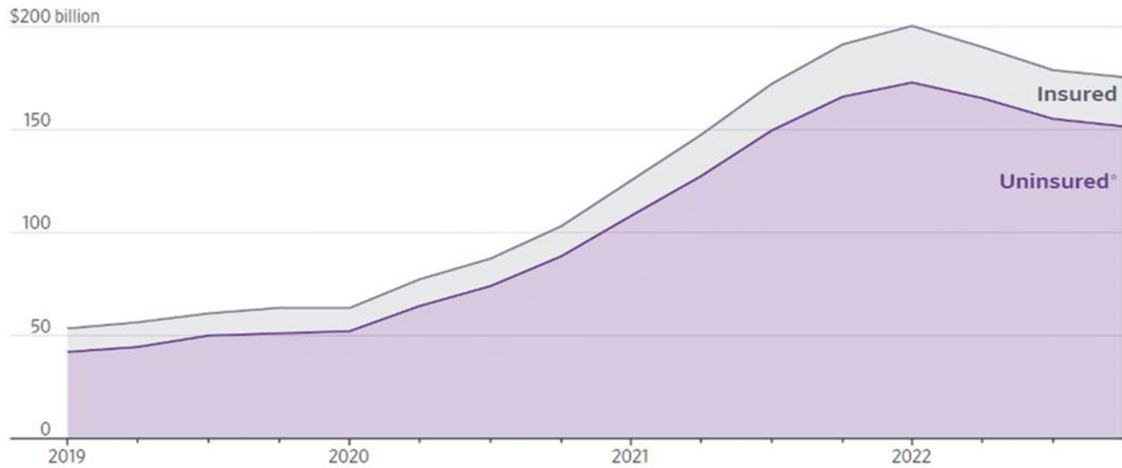
Stress Testing in The Banking Sector

The Federal Reserve Bank now requires large banks in the United States to annually undergo two types of stress tests: the Dodd-Frank Act Stress Test (DFAST) and the Comprehensive Capital Analysis and Review (CCAR). Both DFAST and CCAR are designed to ensure that large banks have appropriate capital levels and risk management practices in place to withstand adverse economic scenarios. Rather than detail the precise measurements and ratios here, suffice it to say that they are numerous and closely regulated.

So, what happened to Silicon Valley Bank (SVB) if there were these "warning signs" inherent in the bank regulators risk management "tool kit?" How do the other banks stand up to this risk assessment methodology?

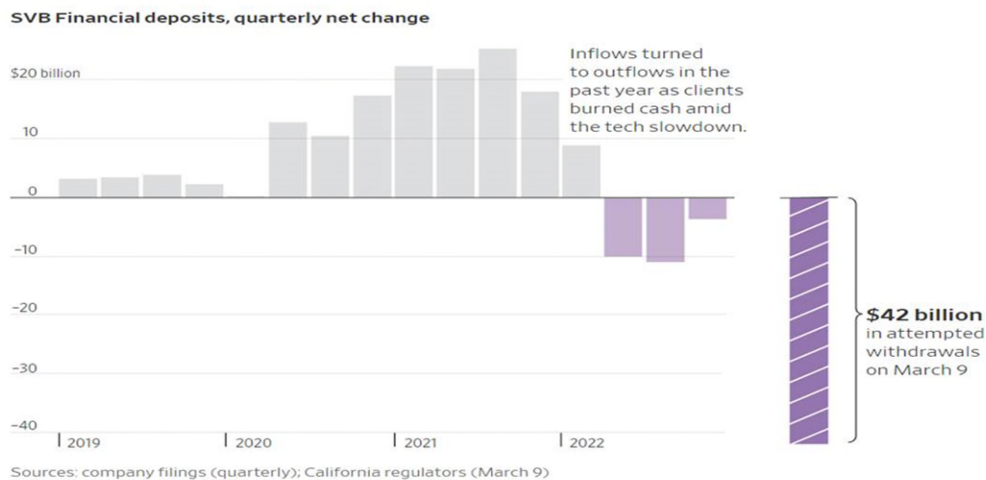
SVB was a victim of its own success.

When the COVID lockdowns occurred in 2020, many tech companies thrived as people stayed home and bought tech stuff. The graph below shows that SVB's deposits ballooned from just over $50 billion in early 2020 to $200 billion in the succeeding 2 years as their banking clients deposited their historical gains.



SVB did what many financial institutions do when deposits grow rapidly, they bought Treasury Bills and Notes, and also invested in Government Backed Mortgage Securities. Since they bought the bulk of these fixed income securities at a time when most Treasuries were yielding less than 1% and Mortgage-Backed securities (GNMA, FNMA, etc.) were paying just slightly above that, the bank experienced massive unrealized losses (on paper) in 2022 and 2023. Since they declared that they were going to hold the vast majority of these now-underwater securities to maturity, they didn't have to disclose these losses in their quarterly reports. Significant impairments were hidden from the public.

But new deposits slowed dramatically as the economy opened back up. The graph below shows exactly what happened to their liquid assets:



So, they were forced to sell billions of formerly "safe" assets to cover withdrawals and then were unable to raise additional capital quickly. Once word got out, the run on the bank by fleeing depositors caused it to be seized.

Could this collapse have been forecasted using the risk assessment techniques designed to do just that?

Here are the metrics (don't worry about the "jargon" just know that they are very important measurements or ratios that all important banks undergo each year) which indicated SVB was more than adequately prepared for a reasonable amount of economic stress (minimum requirements in parenthesis):

	CET 1(Min 4.5%	LCR (100%)	NSFR (100%)	CAR (8%)	NPL (2-3%)	LDR (70-90%)
SVB	8.90%	224%	124%	13.80%	0.18%	89.70%

In fact, in a February 14 article Forbes magazine named SVB one of the top 20 Best (safest) Banks. Every important measurement above was well into the "safest" zone for a bank like SVB. So, the takeaway here is to realize that the major players in the financial system are more closely scrutinized than ever before and all are required to pass annual stress tests to insure their liquidity and viability under foreseeable circumstances. It doesn't guarantee that there might not be a similar "panic" by depositors to grab their money, but most responsible banks haven't degraded their assets by over-purchasing fixed income securities and have adequate liquidity to handle most withdrawal demands.

Importantly and somewhat uniquely, Silicon Valley Bank did not take prudent risk management procedures when their deposits grew to historical levels, and they believed owning a large amount of government backed debt was appropriate. Then the Federal Reserve raised interest rates faster than the bank foresaw and their asset base was fatally degraded.

Because of the overall strength of the banking system, the bank-specific events with SVB and the government's aggressive move over the weekend announcing that all depositors will be made whole, we do not see the failure of SVB as a systemic "infection" that will take down the banking system. It will likely prompt all banks to scrutinize their risk analysis systems more closely. The market is hoping it will force The Federal Reserve to reassess and slow their inflation fighting interest rate hike schedule.