Intelligence MEMOS

From: Duncan Munn

To: Canadians Concerned About Financial Stability

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Re: **The SVB Collapse was a Tale Foretold**

It is said that crises happen slowly at first, and then all at once. Silicon Valley Bank's shocking 48-hour collapse took many by surprise. Yet trouble signs were apparent, most notably, the classic asset liability mismatch that ultimately led to a run on the bank, and Federal Deposit Insurance Corporation takeover.

This is a failure of both governance and supervision.

SVB was highly concentrated on technology and life science companies, which tend to generate significant cash flows and require specialized banking services, and on their venture capitalist backers.

The boom in the tech sector, fuelled by interest rates close to zero, swelled the deposit base. Liabilities went up at a dizzying pace. The problem when liabilities go up that fast is banks have trouble finding suitable assets to offset them. With no better alternatives to deploy the capital, the bank went big into the long government bond market.

The timing could not have been worse.

SVB invested a significant portion of its liquidity in long-term, low-yield bonds, which exposed the bank to interest rate risk in a rising rate environment. As interest rates increased, the value of these bonds declined, resulting in mark-to-market losses for the bank. Many banks are being challenged in this environment, but the size of SVB's problems were massive: adjusting for mark to market losses, the bank effectively had **zero capital**.

An earlier intervention by the board and or regulatory authorities was clearly warranted.

First, allowing an unhedged long bond position to form at a time when inflation was high and central banks were jacking up rates was shockingly imprudent.

Second, someone should have noticed that SVB's ratio of wholesale to retail deposits was a huge vulnerability. Retail depositors tend to be stickier in part because their accounts are small enough to be covered – up to $250,000 in most cases – by federal insurance. Wholesale depositors, on the other hand, hold a lot more so are not covered for that portion if a bank fails. Therefore, they tend to be quicker on the draw, removing their deposits if they get any whiff about the health of their banks. And SVB was very heavily **weighted** towards wholesale deposits.

The joint statement and decisive action of the Treasury, Federal Reserve Board and the FDIC might shore up confidence. Amongst other actions, the Fed on Sunday announced it will let almost everyone have their money. This is exactly the sort of lender of last resort action needed to calm fears.

However, it does raise other issues.

What is the point of deposit insurance if all depositors are made whole? This is especially the case for non-systemically important banks. Clearly the plan is to use the FDIC's fund to keep everyone whole and then likely jack up deposit insurance premiums for everyone else to replenish the fund. This keeps taxpayers of the hook, which is a positive, but does punish those that acted more prudently. Meanwhile, SVB was a well known lobbyist to looser bank regulation and successfully hid mark to market losses by declaring their assets based as Held to Maturity, permitting those losses to escape stress testing.

Regulators have no small culpability here.

At the same time, the stress tests that were devised following the 2008 financial crisis were irrelevant in 2023. This failure wasn't a lack of stress testing; it was gaming the stress tests through asset classification. It was a failure by the board and regulators to deal with the fact that after adjusting for mark to market the bank had almost no capital. That's deeply problematic in a world where most of your deposits are a flight risk.

North of the border we are in better shape. The Office of the Superintendent of Financial Institutions has taken over the local SVB branch, a corporate lending branch that holds no deposits. More importantly, Canada have not seen the gaming of mark to market rules that may have loosened discipline at SVB.

It goes without saying that regulators should ensure that financial institutions hold adequate capital to absorb potential losses in interest-sensitive assets during a rate increase cycle. This may include setting higher capital requirements for financial institutions with significant exposures. At the very least it involves more attention to the stress testing process.

For the time being, the situation with SVB looks contained with the notable exception of Signature Bank. And in Canada, banks typically hold a higher percentage of retail deposits, and are far more diversified than SVB. Nevertheless, our officials must increase their monitoring until matters settle, as OSFI has done with daily testing. They must also stand ready to step up with lender-of-last-resort facilities for any domestically systemically important bank should the need arise. Hopefully the bail-in debt regime enacted after the 2008 financial crisis eliminates that need and the moral hazard that arises with bailouts.

The SVB failure underscores the critical need for prudent governance and supervision and what can go wrong when they are not present. Boards and regulators must not only be conducting stress-testing exercises, but ensuring results are internalized and acted upon.

In Canada, we must also resist any urge to loosen our market rules, which serve as a great prophylactic to poor decisions.

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