NASHVILLE NOTES

The Sawhorse, Silicon Valley Bank and Signature Bank

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As I pen this post I am vacationing on "30A," a prime strip of real estate located along the coast in the Florida Panhandle. Building activity remains robust everywhere as higher rates have not yet clipped activity too much.

Fifteen years ago, I was on vacation at 30A when Bear Stearns CEO Alan Schwartz appeared on CNBC on a Friday morning and assured the world that the company had plenty of liquidity even though he seemed shaken. By the end of the weekend, a shotgun marriage with JPMorgan was announced for a nominal price that virtually wiped out common shareholders but made creditors whole.

During that stay, I looked into the window of a boutique hotel that was under construction in Rosemary Beach. The hotel was nearly complete, but the developer ran out of money. The crews must have been told to walk out, because for the next four years, I could look into the window and see a Big Gulp sitting on plywood that was laid between two sawhorses. In 2013, the Pearl Hotel opened.

I recall this because the Big Gulp was emblematic to me of how long it took to get past the 2008 crash. The financial markets cleared first; real estate markets and "Main Street" took far longer.

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Time will tell what follow-on impacts the failures of Silicon Valley Bank and Signature Bank will be, beyond funding pressure on banks. However, what looks to be unfolding is a blend of 1980 and 2008.

Aside from a botched capital raise that should have occurred before the bond portfolio restructuring, SVB looks like a classic thrift circa 1980, with long-duration assets with low coupons funded with shorter-duration liabilities in a rising rate environment. It took a decade for the industry to get past the mismatch through a combination of thrift (and bank) failures, gradual repricing of assets at higher yields and then rates that trended lower in an uneven fashion.

The 2008 overlay is that capital markets move very rapidly — as seen in the Great Financial Crisis — compared to slow-moving markets 40 years ago. One might argue that the collapse of SVB and Signature was far swifter than the collapse of Bear Stearns and Lehman, whose funding and leverage issues were the subject of Wall Street speculation since mid-2007. *The Wall Street Journal* and other media reported that the mass depositor exodus from SVB was organized in part through customers using Slack and WhatsApp. There are also reports that Peter Thiel's Founders Fund encouraged its clients to pull deposits.

> ***Both banks failed because their asset-liability management failed spectacularly.***

There is so much to unpack in the failure of SVB and to a lesser extent Signature, but two things stand out to me.

One is that both banks failed because their asset-liability management failed spectacularly. In the case of SVB, the large-depositor run may have had a 1-in-1000 probability of occurring; yet it occurred. SVB's deposits were $62 billion as of year-end 2019, then more than tripled to $189 billion by year-end 2021. These largely were not retail and small-business deposits; they were large deposits from sophisticated venture capital funds and venture-backed companies. Or, stated differently, deposits with flight risk.

Signature experienced similar deposit growth, from $40 billion at year-end 2019 to $106 billion at year-end 2021, though more of the deposits went into loans than securities.

I am sure management teams at both banks are despondent that they did not listen to whomever among them was pounding the table to invest most of the torrent of cash in very short-duration instruments. Had this occurred, the large depositors would have had no reason to question access to their funds and start bank runs.

The second takeaway is the irony that SVB, more than any other bank, benefited from the Federal Reserve's monetary policies of zero rates and open-ended bond purchases, which flooded the banking system with cash and the venture community with spectacular wealth as asset values inflated. Signature parlayed the growth in cryptocurrencies that flourished in the zero-rate environment into a vibrant deposit-generating business. And it is important to note that zero rates began in late 2008, not March 2020.

Now the excess deposits are exiting the banking system, and asset values are deflating — especially speculative businesses backed by the venture community. The Fed has been forced to roll out a backstop liquidity facility for banks that I assume will prove to be successful. If not, it will be fine-tuned until it works.

The ultimate balance sheet that may have to be shorn up is the Fed's balance sheet. It contains trillions of underwater low-coupon bonds that are financed with bank reserves, which are short-term, rising-rate liabilities.

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