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Deepanshu Mohan

Financial crisis

Silicon Valley Bank's collapse raises tough questions for the US government, financial institutions

Why did the technology-startup finding bank have so many uninsured deposits. How was such a crisis not foreseen, especially after the 2008 recession?

Outside the Silicon Valley Bank headquarters in Santa Clara in California on March 13. | Reuters

The collapse of the Silicon Valley Bank in America on March 10 is likely to have a global spillover effect on startup companies, especially bigger technology companies that are still under private ownership.

Technology companies in Canada and India, particularly those that invested in the United States to expand their business and parked large sums of money with the bank, have been left vulnerable.

This is among the most significant crises in American banking history since the 2008 global recession when Lehman Brothers, a financial services giant and the fourth-largest American investment bank, filed for bankruptcy.

Several questions emerge: First, what happened with Silicon Valley Bank? Second, why is it important to diagnose its collapse? Third, what does this mean for the American and global monetary policy landscape?

American journalist and commentator Noah Smith and historian Adam Tooze have both published detailed explanations tracing the chain of events that led to the "bank run" – excess withdrawals by individuals and companies – on an "unusual" bank that was largely catering to the financial needs of startup companies.

One can say "unusual" because for an average commercial bank, around 50% of the deposits are "FDIC insured" – or by the Federal Deposit Insurance Corporation. In case of a run on the bank, around 50% of the deposits, or a certain amount, will be covered by the federal government or the Federal Reserve.

But, as is becoming clear now, around 93% of the deposits of Silicon Valley Bank were not insured by the Federal Deposit Insurance Corporation, leaving it vulnerable to a bank run.

Outside the Asia headquarters of the Lehman Brothers in Tokyo in April 2008. Credit: Reuters.

Why did Silicon Valley Bank have so many uninsured deposits? Also, how was such a crisis not foreseen, especially in light of the events that sparked the 2008 recession.? Smith explains it well:

> "Because most of its [SVB's] deposits were from startups. Startups don't typically have a lot of revenue – they pay their employees and pay other bills out of the cash they raise by selling equity to VCs. And in the meantime, while they're waiting to use that cash, they have to stick it somewhere. And, many of them stuck it in accounts at Silicon Valley Bank. Some companies put their money in SVB, because they also borrowed money from SVB, and keeping their money in SVB was a condition of their loan! For others, it was a matter of convenience, since SVB also provided various financial services to the founders themselves."

American banking regulations require commercial banks to hold high-quality liquid assets to meet depositors' needs. These assets can be categorised as available for sale, or AFS, and held to maturity, or HTM.

An available-for-sale asset is a debt or equity security that is purchased with the intent of selling before it reaches maturity date or holding it for a long period should it not have a maturity date, according to *Investopedia*. Held-to-maturity securities are purchased to be owned until their maturity date.

A company's management might invest in a bond that it plans to hold on to till maturity. Silicon Valley Bank invested too much money in such bonds instead of available-for-sale assets.

In the case of available-for-sale asset investments, unrealised gains and losses made from the investment do not directly affect the immediate profitability scenario of the bank. However, investing or booking bonds in held-to-maturity assets – which is what Silicon Valley Bank did – prevents gains and losses from showing up at all as these are seen as investments in the future.

Silicon Valley Bank, too, had invested in held-to-maturity assets without being considerate of its short-term requirements, which is where available-for-sale investments help. This made it difficult for the bank to meet the demands of Silicon Valley investors when they began to pull their money out of the bank.

As *The Wall Street Journal* said: "SVB booked $91 billion out of $120 billion in the most favorable HTM category, and only $26 billion as AFS".

Why would the bank hold only $26 billion in available-to-sale assets when it knew it had a concentrated, high-risk deposit base – startup companies and clients who could withdraw their money in bulk at any point of time?

Given the high inflation rates in the United States, an interest rate hike was likely soon. Federal Reserve Chair Jeremy Powell, had in fact, said as much in November. Yet, Silicon Valley Bank decided not to consider working to limit the risks from a possible rise in interest rates, shocking for the 16th largest bank in the American financial system.

> Breaking down the SVB fiasco pic.twitter.com/QdT5Oh7hoz
>
> — Morning Brew Daily (@mbdailyshow) March 11, 2023

For the second question, diagnosing the source issues of this crisis will shed light on the functioning of the bank within the broader financial system.

Silicon Valley Bank was either incompetent in its handling of deposits and investments, or this was (or is) a case of "moral hazard" – when a borrower knows that someone else will pay for the mistakes they make – of taking excessive risks and expecting political favours and bailouts. This is something Republican politician Vivek Ramaswamy has written about in *The Wall Street Journal*:

> "In 2022 SVB publicly committed $5 billion in 'sustainable finance and carbon neutral operations to support a healthier planet'. SVB's 2022 ESG report lists a litany of 'cross-function working groups', including a 'Sustainable Finance Group' that monitors progress against SVB's Climate Commitment and an 'Operational Climate Group' that "monitors implementation of operational greenhouse gas reduction initiatives." Rather than apply basic risk-management practices, SVB resorted to lobbying for looser risk limits. Taxpayers shouldn't vindicate SVB's political hubris."

Was Silicon Valley Bank confident that the US federal government would bail it out, even if something were to go wrong? Or had it never factored in the possibility of such a crisis hitting so soon and swiftly. A proper investigation will need to answer these questions.

For the third key question, this episode raises issues for the American and global monetary policy landscape that warrant deeper scrutiny.

A breakdown of public trust and confidence in the banking and financial system weakens the "confidence multiplier" effect, as Robert Shiller and George Akerlof argue in their book *Animal Spirits* that was published after the 2008 financial crisis.

In Keynesian economics, increased marginal consumption, or the proportion of money spent to consume from an additional unit of income earned, can induce a multiplier effect ("animal spirits") to boost economic growth. Similarly, a decrease in consumer confidence – in terms of reduced trust in the banking system – can have a negative multiplier effect that hurts savings, consumption, investment and production.

This subsequently affects other macroeconomic aggregates such as (un)employment and investment patterns, which is essential for driving growth.

> President Obama and I put in place tough requirements on banks to make sure the 2008 crisis wouldn't happen again.
>
> The last Administration rolled many of them back.
>
> Americans should have confidence that our banking system is safe, and we're taking action to make it stronger. pic.twitter.com/F3hnWl6L8K
>
> — President Biden (@POTUS) March 13, 2023

So far the Federal Reserve's immediate response has been to offer temporary relief to all depositors and is aimed at instilling confidence in the banking system. But it remains to be seen how overall lending and borrowing patterns to technology firms or startups (most vulnerable by the crash) will be affected ahead. The rest of the banking system is likely to be on the edge, for a few weeks at least.

This episode has also exposed vulnerabilities in the American financial system not seen since 2008. Bankers and financiers who grew up in the low-interest rate regime of the post-2008 crisis failed to prepare themselves for a time when central bank rates would increase the cost of borrowing credit.

> Wall Street lobbyists and Republicans in Congress are pushing Fed Chair Powell for weak capital requirements at exactly the wrong time. Silicon Valley Bank's collapse underscores the need for strong rules to protect the financial system. Regulators must not buckle to pressure.
>
> — Elizabeth Warren (@SenWarren) March 10, 2023

Investors will also be wary of banks that grew rapidly by collecting hefty deposits from businesses and rich people. According to *The Wall Street Journal*: "Shares of First Republic Bank, once an industry darling, have fallen around 30% since Wednesday".

Then, there is the information crisis to battle – not just for banks, but also for political parties and investors – with facts and fiction both proliferating across social media. This is something that was not a factor during the 2008 crisis.

> Congress passed a law in 2018 that lets certain banks, including Silicon Valley Bank, keep less cash on hand to boost profits. SVB has assets; it just doesn't have those assets available right now—a risky move that lawmakers beholden to corporate special interests let happen. pic.twitter.com/dZu8LVRl0L
>
> — Katie Porter (@katieporteroc) March 13, 2023

In the months ahead, and with the American presidential elections due next year, Republicans will turn the Silicon Valley Bank crisis into a political issue.

Under the previous US President Donald Trump, the federal government had relaxed previous regulations, risk and stress test requirements that had been in place for banks under the Dodd-Frank Act, after the 2008 recession. These safety measures had been implemented under former US President Barack Obama.

For now, it remains unclear how the collapse of Silicon Valley Bank can affect the technology startup industry (and other small businesses in and outside the US) in an already complicated global macroeconomic landscape amid high inflation and higher interest rates. This incident will raise critical questions that the American Federal Reserve and the Department of Treasury are likely to struggle to answer.

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