Silicon Valley Bank Collapses!

On the 10th March, Silicon Valley Bank collapsed only 48 hours after a statement released which sought to raise US$2.5 billion to repair a hole in its balance sheet. The difficulties at SVB have brought fear to the banking industry. Furthermore, on the 9th March, investors wiped US$52.4 billion off the market value of the four largest banks with regards to assets. The bank's fallout has triggered the market and hit other Banks, for example Signature Bank and Credit Suisse. This profound uncertainty has a multitude of underlying reasons.

The main triggering cause was the rapid rise in short-term interest rates compared to that of long term interest rates. To understand how this entailed to failure of the bank, one must look at how SVB functioned and made profit. Silicon Valley Bank's main customers are mostly wealthy tech startups and venture capital firms. During the pandemic, the tech companies raised huge sums of money from funding and deposited their discretionary income into SVB. With little demand for loans from this sector, the bank invested most of the deposits into long-term bonds, mostly government and mortgage-backed securities, when interest rates are still low. The US government bonds are considered by the regulators as a low-risk investment, without much credit risk. However, over the past 12 months, the Federal Reserve, the US central bank raised rates from 0.5% to 4.5%. As a result, the US government bond value has dropped rapidly. Moreover, funding became harder in a high interest environment as firms have to withdraw cash in order to keep the company functioning. The bank was forced to sell their bonds to ensure liquidity, causing a huge loss in their balance sheet. SVB's situation kept deteriorating and declared bankruptcy within 48 hours. In short, the underlying problem is that SVB used short-term cash flow to invest into long-term binds, creating liquidity mismatches. Although the investments did not involve much Credit risks, the interest rate risks were not recognised, leading to fatal consequences.

<u>Impacts</u>

The fallout of SVB has exposed the vulnerabilities present in the banking industry. Following the collapse, depositors rushed to withdraw money from their bank account attempting to salvage their finances. Yet the sudden influx in demand for cash exerted further pressure on banks with regards to their liquidity and ability to meet customers' demands. The product of this is further turmoil, with Signature Bank and Credit Suisse enduring hardship. It is hard to deny the relationship between these cases. Moreover, there is an argument that further crises will ensue in the near further due to significant losses in confidence, posing the threat of recession. Looking back to the financial crisis in 2008, bank failures started in February and the corresponding recession began in December of that year. Dhaval Joshi of BCA Research highlighted the fact that banks tend to fall with close temporal proximity to the start of recessions. However, I accept that it may be premature to arrive at this conclusion in the current economic climate.

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It is challenging for the state to resolve this situation, as the US is in a far weaker fiscal position than prior to the financial crisis. High Inflation rates make it virtually impossible to fight these issues with quantitative easing- one possible solution could be to bail banks out, in order to stimulate market calmness and tranquility. However this results in a few problems, one being the concept of a moral hazard. Customers should have recognised the risks when they decided to deposit money in these banks. Therefore they should bear their own risks and losses when banks fail. Besides, it seems morally problematic for the government to use taxpayer's money to help out private institutions. On top of that, it destroys banks' incentives to reduce their risks, as the cost of risky behaviour has lowered, encouraging riskier investments. In a free market, fallouts of banks are part of the market competition which eliminates firms that are not suitable for the market anymore. Furthermore, unlike during the financial crisis, any bailouts today would likely fuel political unrest.

Overall the case of Silicon Valley Bank demonstrates the underlying vulnerability of banks and difficulties of ensuring financial stability by controlling risk. It is definitely a lesson for the financial market and the government regarding raising interest rates