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Portfolio Strategy
Silicon Valley Bank Replays the Ugly Consequences of Disintermediation

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Financial market participants, including the Federal Reserve (Fed), can be forgiven if the Silicon Valley Bank (SVB) mess is bringing back PTSD flashbacks of the Global Financial Crisis (GFC). Even the rare Sunday announcement by regulators that its depositors (and Signature Bank's) would be made whole and have access to their cash felt eerily similar. As did the creation of another emergency facility, the Bank Term Funding Program (BTFP), which is the regulators' attempt to provide additional liquidity and stem contagion fears. I have also been around long enough to bear the scars of episodes where rising rates made many asset liability models go upside down, including the bank and insurance company funding crises of the 1980s and 1990s.

As we often say, history doesn't repeat but it does rhyme. On the surface, the sudden collapse of SVB shared some of the same symptoms of the 2008 meltdown—a financial institution forced by a funding disruption to crystallize crippling unrealized portfolio losses—but the catalyst, the funding model, and the assets are different. Understanding the similarities and differences in these events from financial history is an integral part of our analysis of current conditions and considering how they may play out.

One rhyming theme that runs through financial sector crises is the disintermediation of funding sources. Disintermediation refers to the process by which existing funding relationships that exist with intermediaries, such as banks, are broken. Another way to think about disintermediation is capital rationing, which I talked about in my recent commentary. Recall that the early warning sign of the GFC was in March 2008 when Bear Stearns ran into trouble rolling over its wholesale funding facilities because the firm's lenders did not trust the asset quality of its mortgage book. This forced a Fed-directed fire-sale rescue by J.P. Morgan. At that moment in time a crisis was averted, but it was only temporary as similar situations with Lehman Brothers, Fannie Mae and Freddie Mac, and others popped up in September 2008.

In the specific case of SVB, disintermediation came from SVB's depositors—savers, investors, corporations, venture capital funds—who opted to move their deposits, first slowly and then all at once. While that choice may have initially been to seek higher cash yields or improve their liquidity position, it quickly turned into a bank run flight to safety.

Another common theme in financial accidents is bad management. For example, in the early 1990s in the savings and loan crisis it was poor asset-liability management. The GFC was caused by many parties failing to adequately perform their roles in the mortgage finance process—appraisers, rating agencies, mortgage underwriters, financial engineers, regulators. It is clear to everyone now that SVB's business strategy left it relying on a deposit base concentrated in a relatively homogeneous type of commercial customer. This lack of diversified funding sources was compounded by SVB's portfolio asset allocations. Treasurys and Agencies might not carry credit risk, but they are exposed to market risk that has hit like a sledgehammer during the Fed's aggressive 450 basis points of rate hikes over the past year.

This last point is where SVB changes from an idiosyncratic anecdote to a broader story. The possible systemic element of the SVB situation is the dramatic reshaping of the yield curve over the past year, which affects virtually every financial institution, every levered corporation and household, every bond portfolio. SVB is a mid-sized bank, and calculating exposures to the bank, and similar banks, is a straightforward exercise that every company, bank, and asset manager is doing now if they haven't already. In addition, larger Systemically Important Financial Institutions (SIFIs) are held to a much tighter regulatory capital standard, including capital testing on a portfolio mark-to-market basis. SVB might be the extreme case at the margin that gets exposed first and worst, but for everyone else their vulnerability to a dramatically swift and sharp rise in rates is just a matter of degree and management decisions—we will all see how resilient their funding models are, how matched their assets and liabilities are. We have been focused for some time on identifying and minimizing exposures to investments that are vulnerable to rising rates throughout our portfolios as part of our overall credit and risk surveillance.

The fallout from the SVB situation is still fluid, and we do not believe that this is a Lehman moment. It may, however, be a Bear Stearns moment. The risks in the market that catalyzed the SVB collapse are still out there. Regulators have given financial market participants a break by backstopping the SVB depositors and creating the BTFP. Investors must remain alert to the disintermediation risks that have been brought on by the Fed's unrelenting and ongoing quantitative tightening. Complacency is the investor's enemy.

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