FOUNTAINHEAD INSIGHTS

Market Commentary: Bank Runs – More to Come or Disaster Averted?
March 2023

> "*In an attempt to quell the rising concerns of the bank's depositors and borrowers, the Chief Executive Officer of SVB [Silicon Valley Bank] urged venture capital clients to remain calm and keep their deposits in the institution. The appeal did not have the intended effect. Many of SVB's venture capital customers took to social media to urge companies to move their deposit accounts out of SVB. By the end of the day on Thursday, March 9, 2023, $42 billion in deposits had left the bank.*" – FDIC Chairman Martin J. Gruenberg's remarks to Congress and the Senate on recent bank failures.[1]

In one of the largest heists in history, Sir Francis Drake circumnavigated South America in the late 1570s and stole gold, silver, and jewels from the Spanish[1] worth close to the equivalent of $1 billion in today's dollar.[2] He held his plunder in his ship, the Golden Hind, for close to a year as he worked his way back to England. He then hid his gold and jewels for a bit, guarded by a group of loyal men, while sniffing out the political winds of town.[3] A global bank would have been quite convenient in safeguarding and ultimately transferring his assets.[4]

Nowadays, banks safeguard our cash while providing relative ease of transacting, electronically linking our cash to debit cards, credit cards, technology, like Venmo, savings accounts and many other benefits. Businesses and consumers alike rely on banks for this flexibility and security. For example, as of December 31, 2022, Apple was holding $18 billion in cash[5] at one or more banks. In total, as of March 22, 2023, there was close to $17.3 trillion in US bank deposits according to the Federal Reserve.

Yet, for all the security and flexibility banks provide us, they do not generally charge their clients a fee. Instead, banks have an implicit deal with their depositors: In return for the liquidity, security, and flexibility of depositing your money with them, they have the right to use a significant portion of those cash deposits to make investments and provide loans. *Unfortunately, banks therefore always have a maturity mismatch: clients can withdraw their deposits at will, while banks have ongoing obligations to loan holders, as well as complications connected to exiting investments, that do not match the flexibility of the client.*

The following graph shows the general breakdown of bank assets that are used in supporting deposits (footnote 7):

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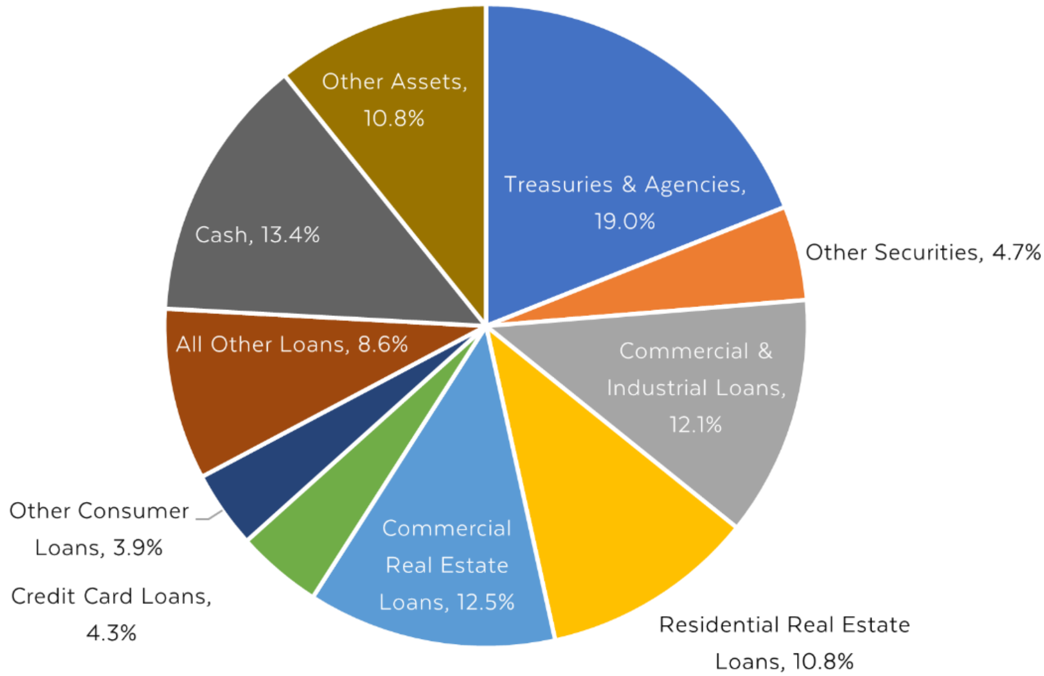
[1] Prior to Drake, the Spanish were the only folks to get to the West side of South America, and they did not believe others could get there, so security was lax.

[2] *In Search of a Kingdom* by Laurence Bergreen is a nice read, linking Sir Francis Drake's adventures to the rise of the British Empire: In Search of a Kingdom: Francis Drake, Elizabeth I, and the Perilous Birth of the British Empire by Laurence Bergreen | Goodreads. The $1 billion is based on memory. It was a large amount…

[3] Was Elizabeth friend or foe? Can he readily share his fortune without being backstabbed? After all, he was technically a pirate.

[4] Modern day global regulation may have tripped him up. There would be a Red Notice placed by the Spaniards and they of course would punish any global bank willing to hold his money. Spain was more powerful at that time than the US is now (though it was soon to be shown they were a paper tiger).

[5] $17,908,000,000 according to their most recently filed financials: 10-Q Q1 2023, 12.31.2022-2023-02-02-10-14 (q4cdn.com)



[6]

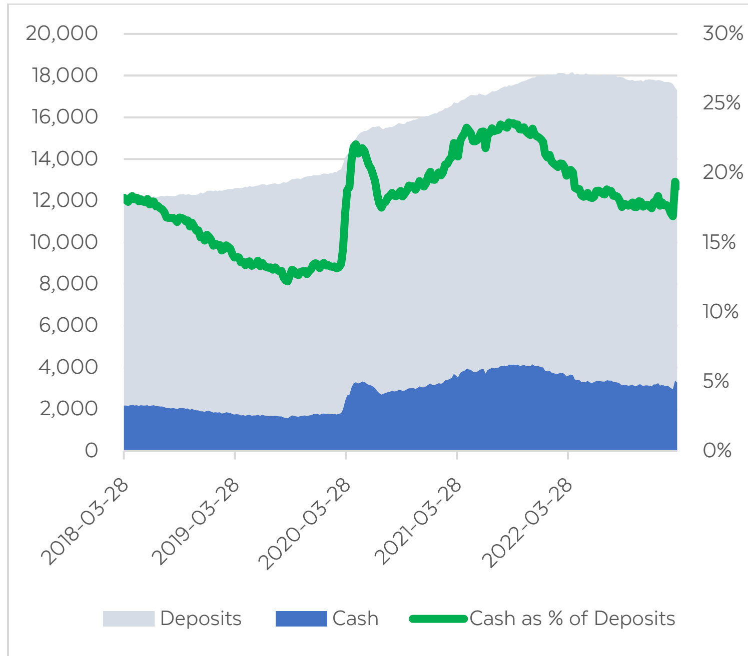
As can be seen from the graph above, cash represents only about 13.4% of assets. The rest is divided between variable and fixed rate[7] loans (52.1%), and various investments such as securities, including US Treasuries and Agencies which are generally fixed rate (34.5%).

A bank has a tough job in managing the necessary cash on hand to meet liquidity requirements, which provides them little to no yield, with the need to generate returns to cover their own costs by investing deposits in relatively conservative securities and providing loans to its clients. The following chart shows that since 2018, on average, banks maintain between 15% and 20% of assets in cash.[8]

[6] Source: Feb 2023, Monthly: Levels, Not Seasonally Adjusted | FRED | St. Louis Fed (stlouisfed.org)

[7] A variable rate will have a yield that adjusts based on the prevailing market yields while a fixed rate will not change for the duration of the loan. Credit cards are examples of shorter term, variable rate loans while traditional mortgages are a good example of a longer term, fixed rate loan.

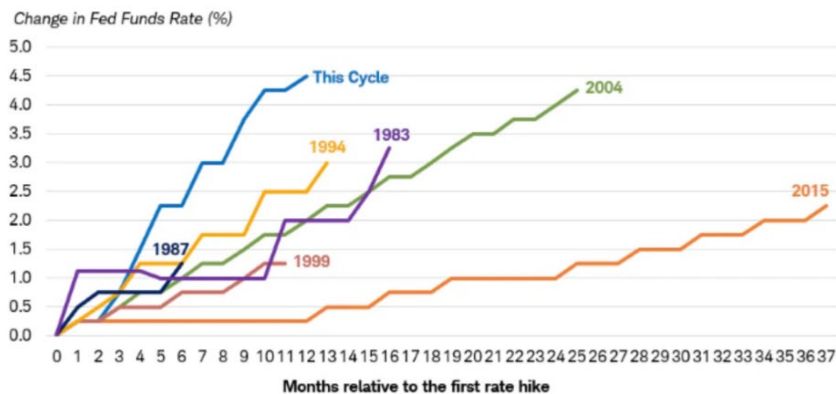
[8] For those math sleuths who may have caught the discrepancy between 13.4% of "assets" and 15% - 20% of "deposits": Bank assets are around 20% higher than cash deposits. The numerator is constant, but the denominator is different. Footnote 7 links to a more detailed spreadsheet. The following graph is compiled from FRED data.



If deposits continue to increase at banks, which is generally the case due to generally upward sloping money supply and wealth, then the risks related to the maturity mismatch of the bank's assets to deposits is generally not an issue. However, the fastest pace of rate hikes in over 40 years is placing stress on banks in three ways:

- Increased interest rates have resulted in over $600 billion in unrealized losses within bank's investment portfolios.[9]
- A tightening of credit may result in more stress on bank loans given a recessionary environment.
- Increased interest rates may also result in depositors leaving banks in favor of higher yields on their cash through investments in Treasury and similar vehicles.

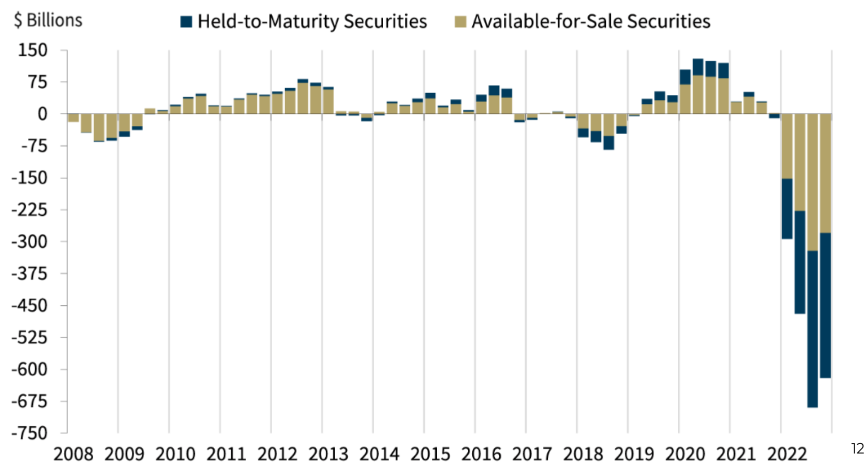
This has been the fastest pace of rate hikes since the early 1980s



Source: Bloomberg, as of 2/28/2023

[9] Note the chart titled "Unrealized Gains (Losses) on Investment Securities as well as the source in footnote 13

$600 billion in unrealized losses sounds like a lot. However, it represents less than 5% of assets held at banks collectively. Furthermore, a majority of those unrealized losses are expected to accrete away as time passes and the underlying security or loan returns to par. The problem, though, is that those losses are not evenly dispersed among every bank for a variety of reasons inclusive of less stable depositors, concentrated businesses, and too high a ratio of longer term, fixed rate assets.[10] For example, Bank of Hawaii has disclosed that they have more unrealized losses than equity and that 52% of their deposits are uninsured, meaning a perceived flight risk of these assets.[11] If customers of Bank of Hawaii get uncomfortable with the state of their bank, there will be a bank run and the bank will have no independent way to stop it. Either a government agency or other banks will need to prop it up given a reasonable justification (i.e., a going concern of for the good of the overall market).



The Federal Reserve is purposely raising interest rates in order to combat inflation. The Fed is also letting assets run off from its own balance sheet which was built up previously in an effort to stem the financial crisis in 2008. Combined, these steps are designed to cool the economy, which in turn assist in taming inflation. However, as discussed on our most recent Investment Wars podcast, the Fed may have a tough task in engineering a "soft landing." If they do not, a recession may further exacerbate both the value and condition of loans outstanding as well as erode deposits. Banks have already been tightening their lending standards which further hurts potential economic growth.

The increase in interest rates has resulted in another stress on bank deposits which is the fact that there are now real yields offered by safe investments like money market funds and US treasury investments. As of the time of this Exploration, Treasury bonds with maturities of less than 1 year are yielding close to a 5% interest rate, while enhanced money market funds are offering around 4.5%.

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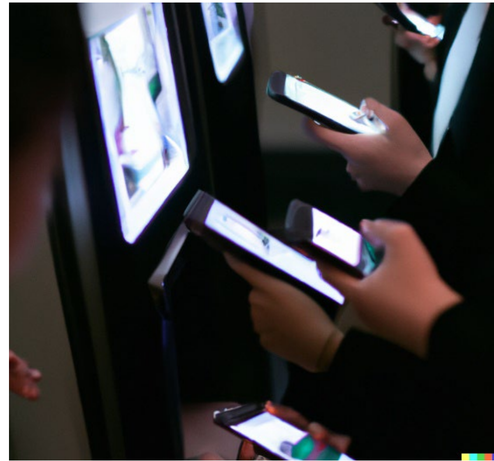
[10] SVB had all three of these issues. Bank of Hawaii may only have the first and third one.

[11] Declines in Loan Values Are Widespread Among Banks – The Wall Street Journal, April 7, 2023

[12] Source: FDIC Chairman Martin Gruenberg Speech & Testimony 2/28/23



[13]

As FDIC Chairman Martin J. Gruenberg highlighted to Congress in the quote at the beginning of this article, Silicon Valley Bank (SVB) was essentially taken down in a day. Information moves lightening quick nowadays and moving money into or out of a bank can frequently be done in less than 30 seconds on one's iPhone. There is no longer the "old fashioned" need to go to a teller at a bank or to learn via newspaper or "non-digital" word of mouth that your local bank may be in trouble. As more Americans and businesses alike realize the yields available to them through savings accounts and the like there may be a more natural emptying of deposits. This will place further pressure on banks to increase the cost of simply maintaining their current deposits. Given banks already invested in assets at a time when prevailing yields were materially lower, increasing current deposit costs will result in further stress to the banking sector.

The S&L crisis of the '80s was born from a similar issue as S&L banks provided consumer mortgages with their deposit base. That material mismatch in duration created zombie banks as yields skyrocketed in the early '80s – an event they were never able to collectively work out of. The financial crisis also knocked out a number of banks that got caught up in some poor lending practices. In fact, bank failures have littered history and will continue to do so given the realities of the mismatch between depositor flexibility and the asset mix needed to support them. Odds are that more bank failures do come but it is important to note that, at least given current dynamics, the overall unrealized losses of the bank sector seem manageable (< 5%) and there are no indications of some of the especially poor practices that may have doomed banks in the past.

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[13] Source: New York Magazine vs Dall*E AI