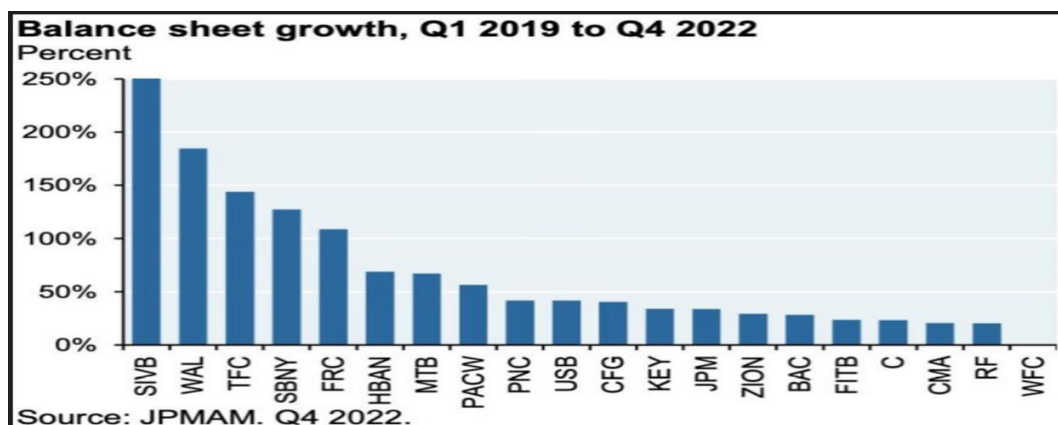


## Once Upon A Time In America

It may seem like the same old story, but this banking crisis is of a different kind from the last one, some 15 years ago. Oddly enough it was the same weekend in March 2008 that saw Bear Stearns effectively go under, when it was put out of its misery by JP Morgan for \$2 a share. Back in 2008 it was a credit crisis that put banks out of business, this time round it's a liquidity crisis that has put two banks into receivership in a matter of days.

How could this happen again, given all the regulation, stress tests and acts of Congress put in place after 2008? In short, the regulation post 2008 focused on what caused the panic last time – Generals fighting the last war and did not consider runs on deposits or a rapidly changing interest rate environment. In fact, the stress tests only took into account how banks would cope with low interest rates, there was no provision for how they would respond to rising rates, let alone at the record pace they have risen over the last 12 months.

There has also been little focus on the concentration risk that Silicon Valley Bank had in its customer base, which given the collapse in Technology share prices, has turned from its biggest advantage to ultimately sinking the ship. What happened at Silicon Valley Bank was the one thing that banks can't manage effectively; when a large number of clients want to withdraw their cash at the same time and that cash has already been loaned out or invested in securities. The bank sold as many securities as they could in order to satisfy those withdrawal requests but sold them at a loss. This, alongside the rout in the bond market, left them with a \$15bn hole in their balance sheet, which wiped out their entire equity value, making the bank insolvent. A failed capital raise meant the bank was out of business in about 24 hours. What made this so quick was the ability for customers to withdraw funds electronically, and when you can do this by phone in minutes, the run became a sprint, and \$42bn was withdrawn from the bank in a day. Social media put petrol on the fire, another factor that was not present during the last financial crisis. Investors and depositors were immediately on the hunt for who else might be in trouble and Signature Bank was put into receivership a day or two later. The chart below shows which banks have grown their balance sheets the most, and this has proved to be the rogue's gallery:



Why should balance sheet growth be the source of concern? This is where the story does rhyme somewhat with the crisis of 2008, and unfortunately, what is not different this time is banker greed. All the banks in the spotlight right now have made risky loans. Silicon Valley had exposure to illiquid Venture Capital and Private Equity investments and was the lender of first and last resort to the whole Technology sector and much of the Biotech sector. Signature Bank had crypto exposure and FRC was also pretty free spirited with its loan book. Yet they paid their depositors virtually nothing, despite the rise in rates. And this has been a big part of their downfall. Had they paid depositors appropriately, and forgone some net interest margin, the story may have played out very differently, and there may have been no run on the bank. Why should depositors accept 0.5% interest at the bank when they can get 5% on 2-year Government paper?

There has been a very quick response by the Federal Reserve and over the weekend they initiated the Bank Term Funding Program which allows banks to swap their securities portfolios for cash from the Fed. This should shore up the situation from a liquidity perspective and as the Government has now extended coverage to non-insured deposits at the stricken banks, this should help with confidence.

A core part of the problem has been the aggressive interest rate rises and therefore the question must be, do these bank failures mean that the Fed will pause? In my view, it's unlikely to affect Fed policy. Their focus is inflation and by enacting the Bank Term Funding Program, they have in effect re-introduced a form of QE for the banking sector, so I don't see them changing their hawkish stance any time soon. The net effect of this whole drama in the real world is further tightening, as banks are going to be less inclined to take risk and will want to reign in their lending standards. This might help the Fed in bringing down inflation and bring a speedier end to the rate rising cycle. The net beneficiaries from a corporate perspective are the very large banks, which are deemed safer, another unintended and unwanted consequence of the debacle.

Despite a lot of volatility in share prices, First Republic Bank was halted no fewer than 25 times in one day on Monday and at one point was -80% intraday, banks and equity markets are bouncing at the time of writing. The answer to this problem is most likely found in other large banks buying the failing banks, as HSBC has done for Silicon Valley's UK business. This will calm investors and halt contagion risks. We have no exposure to banks in the portfolio and despite the better tone to markets are unlikely to start any new positions. Episodes like these rarely happen at the beginning of a sustainable bull market for the sector.

**Felix Wintle, Fund Manager, VT Tyndall North American Fund, 14 March 2023**

Data source: Bloomberg. Atlantic Equities. Hedgeye Risk Management.

**Contact Details:**

Fund Manager – [fwintle@tyndallim.co.uk](mailto:fwintle@tyndallim.co.uk)  
Sales Director – Theresa Russell [trussell@tyndallim.co.uk](mailto:trussell@tyndallim.co.uk)

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Investment Manager: 5-8 The Sanctuary, London, SW1P 3JP.