THE IDES OF MARCH

While several idiosyncratic risks are to blame for the failures of Silicon Valley Bank, Signature Bank and Credit Suisse, the banking crisis stemmed from the impact of unprecedented interest rate increases in 2022. In William Shakespeare's work, *The Tragedy of Julius Caesar*, a soothsayer warns Caesar to "Beware the Ides of March." Caesar was dismissive of the warning, which was in reference to March 15, the day he was ultimately assassinated. The theme of inevitability of fate is expressed throughout the play, much like the inevitability of the economy or financial markets "breaking" under the rapid rise of interest rates. This just happened to also occur during the Ides of March, or more literally, around the middle of the month. The collapse of Silicon Valley Bank (SVB) and Signature Bank (SBNY) resulted in the second and third largest bank failures in U.S. history. The strengths of each bank, like their network of institutional customers with large deposits, became their weaknesses. RMC communicated to clients as the events unfolded as it was important to recognize what exactly was known at the time of the failures. There has been constant coverage and analysis since March that has brought about new information. Like any crisis, the blame game for these failures quickly began to determine who was responsible or who should have seen this coming. SVB has been the primary focus as its failure triggered the crisis. Below is a brief note on each of these parties:

- Among several other missteps, SVB management failed to properly manage duration risk and did not appropriately hedge against rapidly rising interest rates. Ironically, the deposits were backed by "safe" assets like U.S. Treasuries and Agency securities, but the value of these bond holdings plunged as interest rates climbed higher.

- Regulators could have recognized risks and intervened earlier, specifically the Federal Reserve Bank of San Francisco, of which the former SVB CEO served on the board since 2019. If formal actions were taken on previous regulatory findings, this would have been disclosed to the public and management would have needed to address with action.

- Some argue that Congress should not have raised the threshold for Federal Reserve oversight from $50 billion in assets, which stemmed from the 2010 Dodd-Frank law, to $250 billion in assets, in 2018. This rollback in regulation eased restrictions for all banks besides those deemed "too big to fail", with the intent of making community and regional banks more competitive. This is important as, "Banks with less than $250 billion in assets account for roughly 50% of US commercial and industrial lending, 60% of residential real estate lending, 80% of commercial real estate lending, and 45% of consumer lending."[i]

- Auditors at KPMG gave both lenders a clean bill of health 14 days before SVB failed and 11 days before SBNY failed. Accounting rules allow bonds to be classified as "held-to-maturity" if there is intent and ability to hold and not sell. KPMG recognized the large losses but did not question SVB's ability to hold to maturity and did not consider the potential liquidity issue if there were a flight in deposits.

- Wall Street analysts should have realized the potential risks on bank balance sheets, as large securities losses accumulated throughout 2022. Both banks were widely covered by analysts and held in high regard given their track record of managing through prior economic cycles.

SVB management must ultimately be held accountable, as the Fed clearly communicated its intent to raise interest rates, and management inappropriately bet that interest rates would stay low or would come back down quickly. For perspective, consensus projections, including that of the Fed, at year-end 2021 was for a 1.00% fed funds rate by year-end 2022. A few months later, in Q1 2022, this projection increased to just 2.25% by year-end 2022, versus the 4.25 – 4.50% that occurred. Regardless,

management did not appropriately hedge higher interest rates, but that risk was apparently not clear enough for regulators to formally step in. Even if Congress had not eased regulations, it doesn't seem likely that this would have changed the situation. Eric Rosengren, former president of the Federal Reserve Bank of Boston, noted, "The supervisory process has not evolved for rapid decision making. It is focused on consistency over speed. In a fast-moving situation, the system is not as well-designed to force change quickly."[ii] Auditors did not flag an issue with bond losses and liquidity risks, as they were focused on asset quality and credit losses, which had been the source of problems in prior banking crises. Although research analysts have greater access and familiarity to the companies they cover, as compared to the investing public, they are also dependent on management transparency, audit opinions, and regulatory red flags.

In the end, no one seriously considered the possibility of a 21st century bank run fueled by social media and digital banking. JPMorgan CEO, Jamie Dimon, noted in his letter to shareholders, "The unknown risk was that SVB's over 35,000 corporate clients, and activity within them, were controlled by a small number of venture capital companies and moved their deposits in lockstep."[iii] When SVB concurrently announced its bond sale and capital raise on the evening of Wednesday, March 8, which now constitutes as a major communication error, panic spread so quickly that the bank was closed by the Federal Deposit Insurance Corp. (FDIC) before opening on Friday, March 10. This was driven by a perceived lack of liquidity and a crisis of confidence, specifically for businesses that held operating cash at the bank above the $250,000 FDIC insured limit. Aided by the technology to communicate and move money quickly with a smartphone, depositors withdrew more than $40 billion in a day. This contagion spread to SBNY depositors into the weekend until it was closed by the FDIC on Sunday, March 12. Regulators sought to quell the contagion by citing a "systemic risk exception" to backstop all bank deposits, however, deposit flight and capital issues spread to other regionals, like First Republic Bank, that also held a high percentage of uninsured deposits. While SBNY was shut down, First Republic received liquidity from the Fed, followed by $30 billion in deposits from a group of large banks led by JPMorgan Chase. It is likely that the systemic impact on the banking system and potential regulatory changes will take years to fully play out.

The inevitability of further volatility, as evidenced over the last several quarters, highlights the importance of understanding risk tolerance and the need for diversification. It also serves as a reminder that investing carries risk, specifically in equities. Historically low interest rates since 2008 have driven portfolio allocations to equities higher as dividend yields were more attractive than what was available in the bond market. This is not the case in the current environment, as the 10-year Treasury yield remains higher than it has been in more than a decade (although down from its recent high in October). As of quarter-end, the 10-year yield was at 3.49%, which compares well against a dividend yield of 1.7% for the S&P 500. Equity allocations also moved higher as the willingness to take risks became greater, especially during the pandemic, as accommodative monetary policy from the Fed and indiscriminate stimulus from Congress propped up the market and bolstered the desire for higher returns. The willingness to take risk for an individual, family, or institution may not align with their financial ability to take risk, so the overall risk tolerance must be realistic and appropriate for the actual portfolio objectives. A lower risk profile would call for preservation of capital, the need for income generation, or maximizing the longevity of the portfolio. Conversely, a portfolio with a higher risk profile is likely to be invested with a mix of long duration growth stocks, or those that trade on anticipated future earnings, which require patience and a longer time horizon. As always, please contact RMC if you have any questions about your portfolio, changes in your financial situation, or would like to revisit your investment objectives.

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[i] Goldman Sachs, Insights
[ii] The Wall Street Journal
[iii] JPMorgan Chase & Co. Annual Report 2022

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