FACT SHEET | Center for American Prosperity

Understanding the Bank Failures: A Q&A

March 22, 2023

Q: Why did Silicon Valley Bank and Signature Bank fail?

A: Silicon Valley Bank (SVB) and Signature Bank failed for three main reasons:

- The banks made bets on interest rates, creating losses that impaired their capital.
- The Biden Administration's extraordinary level of government spending, after the economy was already rebounding from the pandemic, created 40-year high inflation that required the Federal Reserve to quickly raise interest rates.
- Bank regulators did not sufficiently monitor the interest rate losses banks were taking from the fast-rising interest rates, perhaps because they were excessively focused on the last banking crisis (credit risk) or a political agenda of climate change, racial justice, and ESG.

Q: What were the management failures at SVB and Signature Bank?

A: In many ways, the troubles encountered by SVB and Signature Bank are a classic case of mismanagement of interest rate risk:

- SVB was flooded with deposits during the pandemic—technology companies were highly valued, which enabled them to raise lots of money, and many deposited it with SVB.
  - SVB invested much of those deposits in long-term Treasury bonds. Interest rates have risen in response to the Federal Reserve's efforts to combat inflation, causing bank funding costs to rise and reducing the market value of Treasury holdings as investors more steeply discount future promised cash flows.
- A large decline in the value of the bank's bond portfolio resulted in losses that caused the bank to be insolvent. In 2020, 10-year interest rates were approximately 0.5%. Today they are approximately 3.5%. That means a 10-year bond purchased for $10,000 in 2020 would today be worth only about $7,900 because rates have risen so much.

- SVB depositors got spooked, withdrawing approximately 25% of their money on March 10th alone, after SVB announced that it sold some of its securities at a loss. Other banks that also experienced large deposit increases and invested in long-term treasuries are now under scrutiny as well.

Q: How large are the bank failures?

A: Before its meltdown on March 10th, SVB held more than $200 billion in assets. It is the second-largest bank to fail in U.S. history. Signature Bank was closed by regulators on March 12th, making it the third largest bank to fail in U.S. history.

Q: Why did interest rates rise so much?

A: We saw 40-year high inflation after the pandemic, largely driven by the higher federal spending from the Biden Administration's American Rescue Plan, enacted in the spring of 2021. In addition, the Biden Administration expanded regulations that impaired the ability of the economy to meet the higher demand created by all the stimulus spending, on top of the post-pandemic global supply chain issues. Furthermore, the Federal Reserve waited too long to start raising rates. As a result, we have seen interest rates rising quickly to catch up with all the inflation that has occurred.

Q: Could this have happened at any bank? Or were there factors that made SVB Unique?

A: Bank mismanagement of interest rate risk is as old as banking. However, SVB's clients were highly concentrated in the tech industry. This unique funding base meant that many individual clients had deposits well in excess of the $250,000 limit that the Federal Deposit Insurance Corporation (FDIC) insures ($152 billion out of $173 billion was uninsured).

Q: Were these problems totally unforeseen, or should they have been anticipated?

A: The idea that a bank in SVB's or Signature's position could face financial challenges in the event of a rapid increase in short-term rates is entirely predictable. What was *not* predictable is that the banks would be caught so flat-footed. Both should have prepared for different interest rate scenarios. More importantly, regulators should have been more vigilant instead of getting distracted by political goals like ESG, climate, and racial equity initiatives when they should have been focused on promoting economic growth and financial stability. The fact that the San Francisco Federal Reserve was not robustly stress-testing the effect of interest rate changes calls into question the super regulator approach to bank oversight enacted after the financial crisis.

Q: Does this mean it is a mistake for the Federal Reserve to continue raising Rates?

A: No. Interest rates on long-term securities would have gone up either way because investors demand compensation for inflation risk. Inflation being uncontrolled for too long required steeper rate hikes and created greater risk.

Q: What can the federal government do to address this issue more effectively?

A: The federal government must ensure that regulators are focused on promoting financial stability instead of political goals like climate and racial equity. The government must promote pro-growth fiscal policy that eases inflationary pressure through more supply of labor and capital.

Q: What has the Government done?

A: The bank's equity holders are wiped out, and management has been fired. The Biden Administration has extended deposit insurance to cover all balances.

- The FDIC explicitly insures only up to $250,000 per depositor. Will customers of all banks come to believe that their deposits are implicitly insured beyond $250,000? If that is an objective of policymakers, such insurance should be well-defined and explicit. This is clearly the domain of Congress and should not have been done unilaterally by the Administration.

Q; What <u>should</u> have happened to SVB's depositors?

A: Normally, it would be up to the bank's clients to either diversify where they hold their deposits or more closely monitor the financial soundness of the banks with accounts larger than $250,000. This means that, by the letter of the law, SVB depositors should have been exposed to losses in excess of those borne by its equity holders and more junior creditors. Note that the depositors would not have lost all their money; it is estimated that they would have taken losses of five to ten percent.

- The losses that would normally be borne by uninsured depositors will instead be covered by higher deposit insurance fees at all banks going forward. Though it is not technically a bailout from taxpayers today, it is a bailout from future depositors at all American banks, who are also taxpayers.

Q: DID THE TRUMP ADMINISTRATION'S POLICIES CAUSE THIS?

A: No. The Trump Administration implemented bipartisan legislation enacted by Congress that raised the threshold for which banks are deemed systemically important. SVB and Signature Bank are not at the center of our payment and banking system. Their failures will not bring down the entire financial system, meaning they were appropriately not considered systemic before their failures. However, that does not absolve regulators from monitoring interest rate risk for all banks.