As often happens, a crisis appears suddenly and, upon reflection, observers argue convincingly it never should have happened. March's debacle at Silicon Valley Bank (SVB) is a case in point. Hindsight allows for "Monday morning quarterbacking," yet it occurs with the benefit of information that the non-participant commentator can use to criticize decisions that were taken. In SVB's case critics likely intoned, "What were they thinking?"

SVB was intervened by the FDIC on March 10, 2023. As recently as January 19, 2023, when the bank presented its 2022 results, it appeared to be well capitalized and delivering excellent financial metrics for a bank. SVB's balance sheet boasted assets of $212B, $15B in cash, $117B in high quality fixed income investments, and $74B in net loans. The intervention was triggered by a bank run that occurred after the bank announced an equity offering on March 8. As part of the marketing SVB disclosed it had realized a sizeable loss on the sale of part of its securities portfolio, which suddenly alerted the world to the reality that SVB had an extraordinary duration mismatch between its assets and liabilities. Even the server at the sandwich shop told us, you cannot do that.

The FDIC, Treasury Department, and Federal Reserve acted quickly to prevent contagion and stem the damage to regional banks, key intermediaries for small businesses. Initially, the FDIC offered depositors the insured share of their deposits with a plan to return the rest, as possible, after the liquidation of the bank's assets. In many interventions, the FDIC tries to find a buyer that can take over the bank quickly and become responsible for orderly management of the assets and liabilities. The FDIC attempted a quick SVB sale unsuccessfully. Worried about the possible implications of an incomplete resolution, the Treasury and Fed deemed SVB a systemically important financial institution (SIFI) which enabled them to, in effect, guarantee the deposits. Not surprisingly, the media, politicians, economists, and pontificators had to opine.

Should investor deposits be guaranteed? This is a simple question for which in our opinion there is a simple answer, yes. However, the guarantee should be for demand deposits, and it should not come from the U.S. government or any governmental organization. The guarantee should be a reliable assurance from the bank given the way it should be required to manage its liabilities.

Banking and financial services have changed dramatically in the last 20 years. Some people do not even use banks anymore as they have rapid and flexible access to savings held in money market funds or other non-bank institutions. Thinking about money like any possession, people hold it somewhere until they need it. Demand deposits should be treated as money a bank holds for its owner and which should always be readily available to pay bills, obtain cash, or transfer for another purpose. The bank facilitates the disposition of the money sometimes for a fee and others for free. Historically, demand deposits were accessed via tellers or checks. Technology virtually eliminated the need for these, replacing them with digital wallets.

Investors in money market funds have virtually no risk of loss (government funds assure no risk of loss). If investors can "deposit" money in a fund that pays a return and has no risk of loss, it stands to reason that money deposited temporarily at a bank should not have risk of loss. Conceptually, the bank could just put their clients' money in a money market fund to be assured it would be available when needed.

Banks are highly regulated entities that will likely face additional regulations after the SVB fiasco. The public should be entitled to assume that if an entity has authorization to operate, regulators reviewed the entity's credentials and vetted basic operating procedures. To remove the SVB risk, banks can be required to maintain sufficient liquidity, i.e. invest in money market fund equivalent assets to cover the majority of its demand deposits. While this would seem like a relatively obvious way to handle a short-term liability, many banks use sophisticated systems to calculate their daily flow risk and often mismatch the duration of their assets and liabilities, as SVB did. Embedded in such a process is the assumption that all deposits will not be requested at once, and that deposits tend to grow rather than decline.

There are many implications associated with a proposal that modifies the way banks manage client deposits including the availability of short and medium-term loans, a lower return on capital for bank investors, a reduction in net interest margins, and challenging regulatory supervision. However, a fundamental difference between demand deposits and funds "purchased" for on lending is the assured liquidity the depositor expects. SVB suffered the first "Twitter run" and a digital wallet drain. With so many cash management alternatives today, we think it behooves banks to modernize and take minimal risk with money they were given to hold rather than invest. Bank disintermediation is a reality that individuals and institutions will likely continue to pursue as non-bank competitors offer more services. This may mean banks need to shift their asset composition and revenue mix because ensuring the integrity of deposits should be a bank's priority, not the government's responsibility.

April 15, 2023

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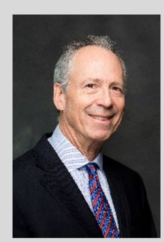

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