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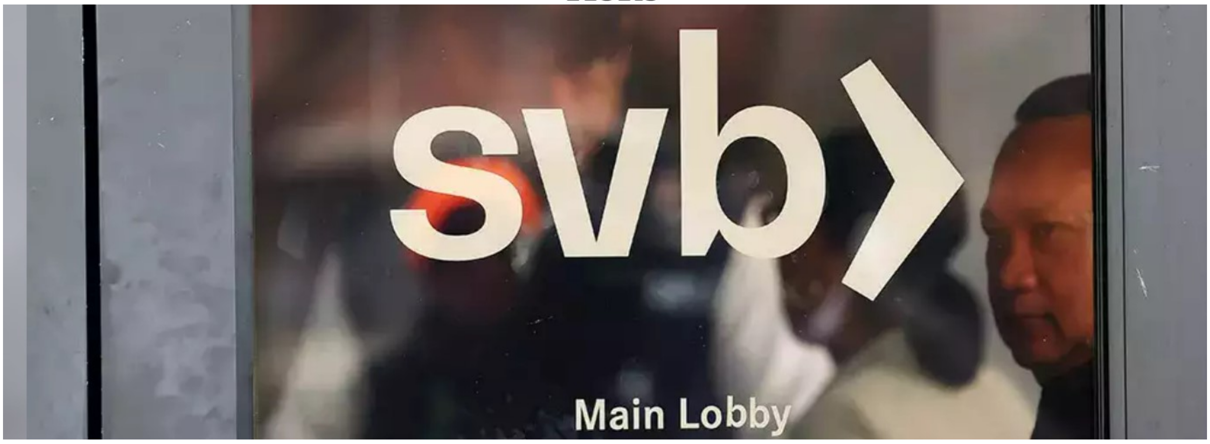
Learnings from SVB and Credit Suisse: Two tales of systematic and unsystematic risks



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And the story goes on like this.

There is this bank named **Silicon Valley Bank** (SVB) that lent money to the tech industries, and start-ups primarily in the tech domain.

On March 10, 2023, SVB collapsed as it did not have enough funds to pay back to its depositors. SVB was the biggest US lender to fail since the 2008 global financial crisis.

What happened? To know about the origin of the debacle we will have to step three years back.

In March 2020, the world saw an outbreak of Covid-19. Economies around the world were not prepared to face this 'exogenous' shock, and the GDP growth collapsed. Now, there is a prevalence of demand- and supply-side shocks.

Demand has fallen because of lack of jobs and loss in livelihood. The supply-side disruption happened as people stopped going out for work. Also, international trade got disrupted because of supply-chain disruption, in particular from China. This meant cheaper imports also stopped coming.

The US economy suffered one of the sharpest contractions in its history during 2020.

To fight the fall in growth rate, the US government followed a massive expansionary fiscal policy. The US government pumped USD1.5 trillion to save the economy during the pandemic. The money pumped was almost half the size of the Indian economy, estimated to be around USD3 trillion.

The generous social security meant that the US workers did not have to work and money kept on coming to their bank accounts. Depending upon the states of stay, the US citizens were receiving anything between USD600-USD900 per month from the government exchequer.

And this was happening while the workers stayed back at home without any 'real' addition to the economic output. Demand remained intact with the help of social security whereas there was a gradual fall in real economic output.

However, as the economy gradually started opening up starting early 2021, the economies across the world grew much faster than anyone expected. That mismatch between supply and demand drove up prices higher and higher, known as inflation.

Simultaneously, between 2020 and 2022, commercial banks faced the problem of plenty. Banks were flushed with funds and SVB was no different. Moreover, for the SVB bank, it was also getting back deposits from their cash-rich tech clients (doing good business during the pandemic) and their deposits doubled.

Like any other commercial bank, SVB wanted to lend out excess deposits. In fact, commercial banks operate on the principle of lending out their excess deposits to other depositors, firms/businesses, or even government agencies.

The banks make money, as there is a difference between the bank lending rates which is higher than the deposit rates.

For example, if you put your money in the bank you get a fixed deposit rate of 6% which is lower than when taking loans from the banks. The caveat is that the business that the banks lend money to, does not go kaput and/or the assets where the banks invest, say for instance, government bonds or gold or commodities do not lose value.

In the case of SVB, the management thought about playing safe and they in turn parked almost three-quarters of the incremental in-demand deposit that occurred between 2020 and 2022, in well-rated US treasury bonds and other secured debt market instruments.

Although considered safe, the problem was SVB used its short-term deposits and invested in long-term low-yield securities. The thought process was that the US treasury bills are the safest assets and the yield to the US bonds during 2021 was quite low meaning that the bond prices (value of the assets) were high. So, it is a good deal as even if they want to liquidate bonds they would realise good money.

What the SVB management could have never foreseen is that the quantitative easing of USD1.5 trillion will, within a matter of two years, drive US inflation to forty year high. The US inflation breached 9% reaching a high of 9.1% in July 2022, against the Fed's control limit of 2%.

The US Fed started fighting this inflation though a bit late. And in an attempt to do so, it increased its rates too fast and too high. The one-year US treasury rate increased almost 500% from 1% during Covid-19 times to almost 5% levels in early March 2023.

This meant the value of the bonds that SVB was holding in its portfolio fell, and SVB stock crashed almost 60% in a single day last Friday. The bank lost USD1.75 billion in a single day.

The case of SVB is that of a systematic (market) risk. SVB and many other banks like Silvergate and Signature banks played safe by parking excess deposits in government securities.

When bond yields went up all of these banks made losses. These banks were now paying 5% for their deposits whereas getting a yield return of 2% which was showing losses in their account.

Also, once the economy came out of Covid-19, profitability of the tech firms started falling. Corporations across the world came out from the online to offline mode, which meant less use of data. The profitability of tech firms fell.

This led to big tech companies, including Meta, Google, and Microsoft laying off thousands of workers. Therefore, SVB also started losing money from their clients, which were primarily tech firms.

Before the world could fathom the **SVB crisis**, soon there was news that Credit Suisse (CS), one of the largest investment banks in Europe, was also taking a hit. Now the case of CS falling is a classic example of unsystematic risk or credit risk.

CS lost money because of lending out to a series of businesses that went bad because of accounting fraud and investing in high-risk assets — a classic example of credit/unsystematic risk.

During the last three years, CS lost money because two of their biggest clients, hedge funds companies, namely, Archegos and York Capital Management, lost close to USD5 billion. Earlier, the bank lost close to USD10 billion lending to an invoice discounting firm named Greensill Capital, UK; and another USD1 billion lending to Wirecard AG, Germany.

Losing money because of bad investment has nothing to do with the central banks across the world following a quantitative tightening policy.

Moral of the story, economics always operates with both hands. And as the present case suggests, at times, both the hands can go wrong.

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