

What are the lessons for Europe from the demise of Silicon Valley Bank?

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Silicon Valley Bank (SVB) has gone from hero-to-zero in 48 hours. From established bankers to start-ups in the tech, fintech, and biotech industries and to Napa Valley's premium wineries on Wednesday 8th March to closed by the Californian financial authorities on Friday 10th March.

The main question for Europe from this disaster is which European institutions have, like SVB, bought fixed-interest bonds during the period of very low interest rates and in what quantities and maturities.

The knock-on questions are:

- What is the accounting basis on which these bonds are being held?
- Does this accounting conceal unrealized losses in a meaningful proportion of the institution's equity?
- Has the institution used these bonds as collateral, for example in a derivatives clearing house or for loans from a central bank?
- Does the central bank or derivatives clearing house use the face value of the bonds as its basis, or their market value?
- Is the central bank or derivatives clearing house adequately collateralized?

Why did SVB go under? It experienced a major inflow of new funds in 2021-2 deriving from high Venture Capital (VC) investment in start-ups, resulting in \$169bn of customer deposits.¹ SVB must have calculated the 'cash burn rate' of these start-ups and the likelihood of further VC investment in the sector, and matched its cashflow calculations by placing a large amount of these funds - \$120bn at 31/12/22 - into fixed-rate bonds maturing 1-6 years in the future.²

Instead, the 'cash burn rate' rose and new VC investment fell, and SVB experienced a steady outflow of deposits. Interest rates rose in parallel and the bonds fell in market value. On 8/2/23 SVB sold the entirety of its trading book of bonds, called 'Securities available for sale'. They were held in SVB's accounts at near their market value: SVB raised \$21bn in cash but experienced (i) a loss of \$1.8bn; (ii) a consequential reduction in its equity from \$16bn to \$14.2bn. Questions must be asked about why the book value was off-market by \$1.8bn at \$22.8bn at the time of sale, and what happened between (a) 31/12/22 when the portfolio was valued at \$26.1bn and (b) 8/3/23 when it was valued at \$22.8bn, a difference of \$3.3bn.

The larger part of the portfolio - 'Securities to be held to maturity' – stood at \$91.3bn at 31/12/22 and apparently at \$95bn on 8/3/23, an increase of \$3.7bn. These bonds were held in SVB's accounts at the lower of their cost or their face value, regardless of their current market value.

¹ Plus as much as another \$160bn of client funds which were not on SVB's balance sheet but which it was managing

² Our data is drawn from SVB's year-end 2022 accounts as contained in their 10K filing, and a slidedeck entitled 'Strategic Actions/Q1'23 Mid-Quarter Update' was published on Wednesday 8th March, the day it all went wrong

They already harboured an unrealized loss of \$15.1bn at 31/12/22 – almost equivalent to SVB's equity - and we need to know how the increase came about, and whether it was connected to the fall in the balance of 'Securities available for sale': were bonds transferred between the two portfolios? If so, at what price? Were bonds transferred at their face value or cost, resulting in the appearance of a profit in the 'Securities available for sale' portfolio, but an increase in the unrealized loss in the 'Securities to be held to maturity' portfolio?

On 8/3/23, SVB announced a capital-raise of \$2.25bn to replace the loss of \$1.8bn on the liquidation of 'Securities available for sale'. Instead, depositors tried to withdraw their funds, the capital-raise failed, the shares were suspended - and the bank was closed on 10/3/23. Anyway, SVB had negative equity: \$14.2bn apparent equity outweighed by an unrealized loss of at least \$15.1bn on its 'Securities to be held to maturity'. It had to be closed, but this was little worse than its position on 31/12/22.

The worrying issue for Europe is that bond issues with almost no yield, or a negative yield, were hoovered up by financial markets over recent years. Issuers like the EU (for the Coronavirus Recovery Fund), the European Investment Bank, and the member states themselves had no problem in getting their new issues subscribed. Who bought this paper? Who is holding it now and at what value in their own accounts? The face value, the price paid (which may have been higher than the face value), or the much-lower market value?

Are these bonds being used as collateral for loans from the Eurosystem, or the Swedish Riksbank, or the Danish National Bank? What security margin (or 'haircut') is taken, and is the 'haircut' taken in relation to the face value or to the market value?

Are the bonds being used as collateral to secure positions at a derivatives clearing house i.e. as 'margin'?

Annual bond issuance – by EU member states, by their agencies, by other public sector entities, by banks and by private issuers – is in the region of 20% of EU GDP per annum, or EUR3 trillion.³ If the average maturity of the bonds is 7 years and interest rates rise by 2.5%, a mark-to-market loss of around 17.5% of face value – EUR525 billion - is produced for the bondholders.⁴ If one considers all bonds in issuance (7 years @ EUR3 trillion per annum = EUR21 trillion), then the latent loss @17.5% of face value would be just under EUR3.7 trillion.

That will be the broad scale of loss sitting in the European financial system after medium-term interest rates have increased by 2.5%. So the question is who is sitting on that loss, have they admitted to it in their accounts, and are they transmitting that loss latently through the system by having others share in the risk of their over-valuation: what borrowings and derivative positions are now under-collateralized? That is what Europe needs to be asking itself in the wake of the sinking of the good ship 'Silicon Valley Bank'.

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³ EU 'General government gross debt' as tracked by Eurostat is 90% of EU GDP, which is around EUR15 trillion. If the average maturity of that debt is 7 years, EUR1.93 trillion of debt matures and is rolled over each year. The remaining EUR1.07 trillion of annual issuance is an estimate for all bonds issued by other entities

⁴ 2.5% is a broad average of the rise in yields on the government bonds of the main Eurozone member states since 1/1/22