Outside the Box

Opinion: Silicon Valley Bank survived the dot-com crash and the Great Recession, but SVB met its match in Powell's hawkish Fed

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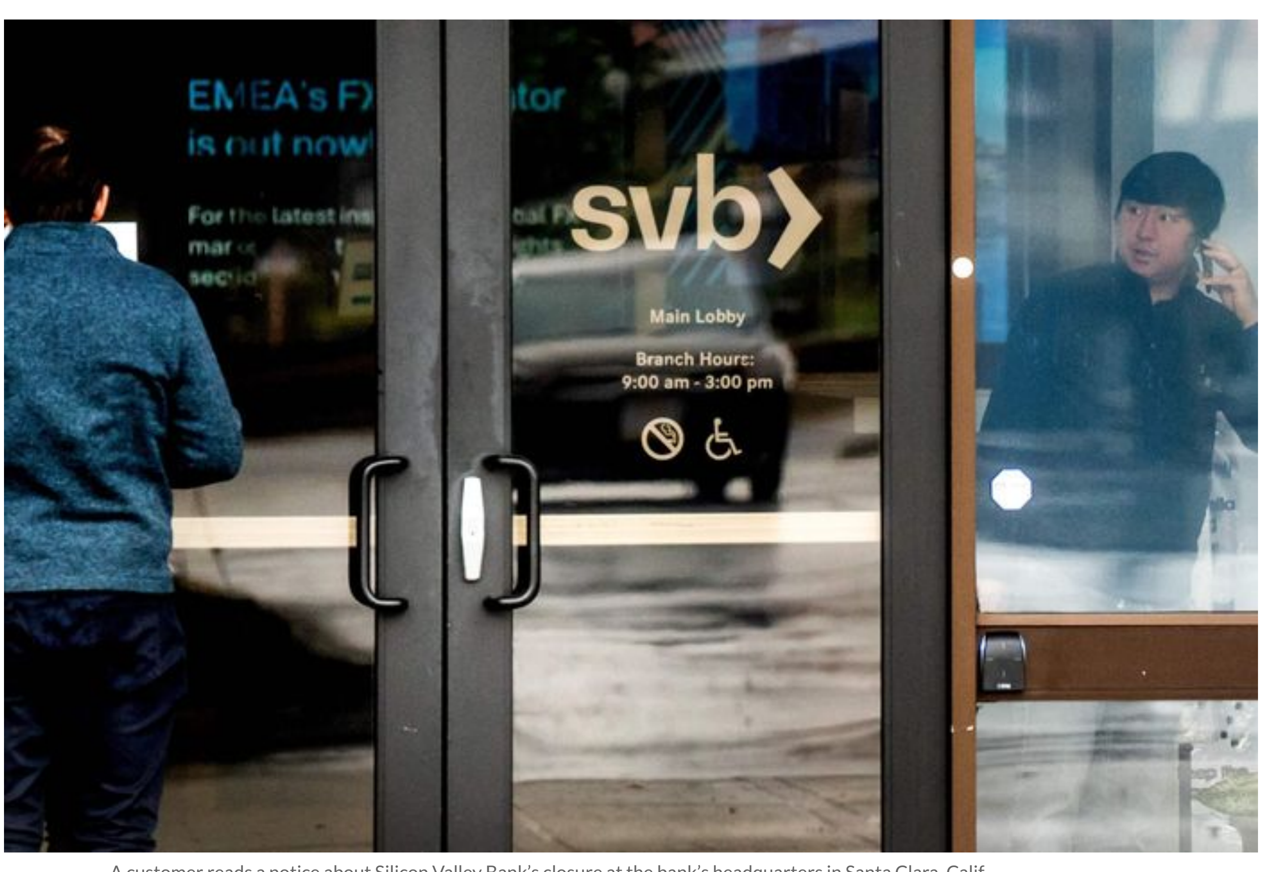
SVB has always been vulnerable to tech-industry startup booms and busts



A customer reads a notice about Silicon Valley Bank's closure at the bank's headquarters in Santa Clara, Calif.
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Silicon Valley Bank (SVB) **SIVB, -60.41%** has long been an integral part of the Silicon Valley startup scene, lending money to venture-capital-backed companies and holding their operating cash as bank deposits. SVB has always been vulnerable to startup booms and busts — nearly drowning during the popping of the dot-com bubble and during the Great Recession of 2007-2009 but it did survive.

Not this time.

The Federal Deposit Insurance Corporation shut down Silicon Valley Bank on Friday and transferred all of its insured deposits to a newly created Deposit Insurance National Bank of Santa Clara (DINB), which will be open for business on Monday.

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Some of SVB's problems were unsurprising. Shaky startups were simultaneously struggling to make loan payments and withdrawing cash to cover revenue shortfalls. Rumors of trouble at SVB accelerated its problems by encouraging depositors to pull out every penny above the FDIC's $250,000 deposit-insurance limit.

What was different this time is that — unlike the dot-com bubble and the Great Recession — the Fed is aggressively raising interest rates to squelch inflation. The more relevant historical parallel is the savings and loan crisis of 1979–1982.

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In the 1970s the U.S. economy was hit by oil embargos, massive government budget deficits and easy-money policies intended to finance the deficits and avoid the unemployment that might result from higher energy prices. After the rate of inflation hit double-digit levels in March of 1979, Paul Volcker became Fed Chair that August with a mandate to crush inflation. He was eager to do so.

As interest rates rose, savings and loan associations (S&Ls) that had financed long-term mortgages with short-term deposits were crushed. The aggregate net worth of S&Ls fell to a negative $44 billion at the end of 1981 from positive $23 billion at the end of 1977. The S&L industry was bankrupt. Almost a quarter of the S&Ls operating in the 1970s collapsed or merged in the early 1980s.

Sound familiar? Higher energy prices. Huge budget deficits. Easy money. This time around, the banking industry was supposed to have learned its lesson from the 1979–1982 S&L crisis. S&Ls had been decimated by the surge in interest rates because they had mismatched durations — they borrowed short and lent long.

When interest rates rose, S&Ls had to pay their depositors higher rates while the income from their mortgages was fixed. In addition, the market value of their long-term mortgages fell while the market value of their short-term deposits did not.

An obvious solution is to eliminate the duration mismatch by moving to shorter-term loans and longer-term liabilities. Another strategy is to use options and futures to hedge their interest rate risk — if rising interest rates cause capital losses on their mortgages and other long-term assets, these can be offset by capital gains on their bond options and futures.

SVB is likely not the only bank that ignored the lessons of the S&L crisis.

It has now been 40 years since the S&L crisis and some lessons have evidently been forgotten. We don't yet know for certain but it seems that the collapse of Silicon Valley Bank — the 16th largest U.S. bank — was caused by an unhedged duration mismatch. SVB used short-term deposits to invest in long-term bonds, mortgages, and stocks. As the Fed increased interest rates to slow inflation, the market value of much of SVB's portfolio collapsed. When depositors started fleeing, SVB couldn't sell their diminished assets for enough to cover the deposit flight.

Read: Silicon Valley bites the hand that feeds it in SVB bank run

What's next? SVB is likely not the only bank that ignored the lessons of the S&L crisis. We may soon find out how many more dominoes will tumble.

What about interest rates? So widespread and severe was the damage during the S&L crisis that market strategist Edward Yardeni defied conventional wisdom and predicted the Federal Reserve would lower interest rates to bail out the S&Ls and banks that had borrowed short and lent long: "The Fed must lower interest rates to offset the erosion of the financial system's net worth. . . . Otherwise the financial system will collapse."

Yardeni was right. In the fall of 1982, the Fed decided that an inflation rate below 4% was good enough. The Fed switched to easy-money policies, supplying funds as needed to bring down interest rates, encourage borrowing and spending, and fuel the economic expansion that lasted the remainder of the decade.

If the banking system is as fragile today as it was then, the Fed will have to do the same. My guess is that most banks — especially the largest banks — are fairly well protected from the Fed's current war on inflation. SVB will not be the only bank to fail but we are not likely to have a full-on repeat of the S&L crisis.

Gary Smith, Fletcher Jones Professor of Economics at Pomona College, is the author of dozens of research articles and 16 books, most recently, Distrust: Big Data, Data-Torturing, and the Assault on Science (Oxford University Press, 2023).

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