view from the Thames by Deon Gouws fm

123RF/Michael Burrell

When a bank gets screwed

The recent demise of Silicon Valley Bank (SVB) reminded me of something I heard at a course I attended in London in 2000. One of the presenters was professor Ingo Walter of the Stern School of Business in New York. As a German finance academic living and working in the US, he was eminently qualified to comment on some of the key differences between the two countries, focusing inter alia on the way that banks and their customers behave.

Walter gave the example of someone who wanted to buy a new big-screen TV. If you're in Germany, the first thing you're likely to do is to look at your most recent bank statement. If you have enough money, great, go out and make the purchase, otherwise start saving until you can afford to buy it cash. Over the months that follow, the bank will pay you a measly interest rate on your deposit — "for that is what banks do, they screw you", according to the good professor.

If, on the other hand, you're living in the US, you'll probably just go out to Walmart and buy that TV set without considering any bank balance. Only when your next credit card statement arrives in the post might you realise that you never had enough money to buy the big-ticket item in the first place. Which means that the bank will finance you until the debt is fully paid off, at a penal interest rate, no doubt — "for that is what banks do, they screw you".

The moral of the story, according to Walter, is this: it doesn't matter where in the world you happen to find yourself, one thing is certain, and that is you will always be screwed by the banks ... but, if you're lucky enough to be in the US, at least you can watch TV while it is happening!

This anecdote is not only amusing, it's also instructive in that it provides a simplistic explanation of the modus operandi of any bank: gather assets from depositors who have spare cash, and use that money to provide loans to those who need it. The difference between what's paid out on the former and what's earned on the latter is the interest rate margin.

Perfect storm

Enter SVB. As the name suggests, this financial institution positioned itself at the epicentre of the US's technology industry. It became a badge of honour to bank with it, signalling to counterparties that you have a cutting-edge business model and limitless potential. Practically every budding unicorn that had raised a few hundred million dollars would stash that cash with SVB, continually swelling the bank's deposit base (or the liability side of its balance sheet, in boring accounting terms).

While this all sounds marvellous from SVB's perspective, there was one problem: practically nobody in the hi-tech ecosystem was interested in helping with the other side of SVB's balance sheet by borrowing from it at inflated interest rates. Why would you, when venture capital angels throw vast amounts of free cash in your direction at a near infinite multiple of potential earnings many years out?

SVB thus had to find something else to do with all that cash from depositors. So, it started buying bonds. And with interest rates at or near zero until a year or so ago, the only way to eke out a bit of interest rate margin was to buy longer-dated securities. Which worked wonderfully, until it stopped working a month or so ago.

The bank suddenly faced a perfect storm, with problems on both sides of the balance sheet. Depositors were deserting it, not by queuing around the block to withdraw cash, but simply by making a few clicks (they're techies, after all). To make payments, SVB had to sell down long-dated bonds and realise big mark-to-market losses, given that interest rates have ballooned over the past 12 months, courtesy of the US Federal Reserve.

They say equity is that thin sliver of hope between what you owe and what your assets are really worth. In SVB's case, this sliver evaporated practically overnight, and it had to be rescued. A turn-up for the books, you might say: not screwed by the banks, but a bank itself that got screwed. One wonders whether the directors were watching TV while it was happening. x

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