PENSION & WEALTH MANAGEMENT ADVISORS
IMPROVING FINANCIAL SECURITY

800 SOUTH STREET SUITE 160 WALTHAM MA 02453 t 781.398.0077

BULLETIN: Silicon Valley Bank & Proper Risk Management

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OVERVIEW

"May you live in interesting times" is an English expression that is claimed to be a translation of a traditional Chinese curse. While seemingly a blessing, the expression is normally used ironically; life is better in "uninteresting times" of peace and stability than in "interesting ones" which are times of turmoil.

That quote seems all too appropriate over the last 24 months since COVID-19 engulfed the world. Although the pandemic is over, we are still working off the excesses and shortages of the crisis - and Silicon Valley Bank's failure and perhaps others coming this week are just some of the unexpected collateral damage.

While we will provide some insight on what is happening, we wanted to start with the things that you can do to ensure proper risk management at the household and business level.

IMMEDIATE ACTIONS

1) Reduce Exposure to Any Single Bank

Reduce your exposure immediately to anything above the FDIC limits of $250,000 per account. Basic risk management is crucial when dealing with all investments - including and perhaps especially banks. If you have not done this already - prioritize this now - and in the future.

2) Use "Non-Balance Sheet" Accounts

Banks love to have clients place assets in savings and checking accounts and CD's. They pay you a low rate - and then immediately turn around and either lend it to your neighbor at a higher rate - or - invest in the markets directly. They keep the "spread" on between what they pay you and what they get in market - usually about 2-3% for the effort.

The problem is that your deposit becomes part of the bank's balance sheet and assets when you have any kind of a deposit. The more aggressive they are in investing their portfolio - the bigger the spread - and the bigger the risk to the bank and their customers. All it takes is a 10% loss on the loans, investments, or client withdrawals in a single day to have a bank fail. This is what happened to Silicon Valley Bank.

If you choose to stay with your bank, they also have non-balance sheet options for you to use - although they make much more money on your bank deposits and will typically encourage you to keep your demand deposits instead.

There ARE ALTERNATIVES outside of banks - that are interest-bearing, have check writing and bill pay services that are absolutely NOT part of the any institution’s balance sheet. A money market mutual fund is one example - and many of them are yielding over 4.5% now without any lock ups.

Fidelity, Schwab, Vanguard and other custodians have the exact same capabilities as any bank - but without the balance sheet risk. Many of our clients have these cash management accounts and have not had traditional banking relationships for many years.

3) Alternatives to "Quid Pro Quo" Lending

Banks will often provide loans at slightly lower rates for mortgages and asset-based lending if you "consolidate the relationship" with them. Essentially choose their other services like investment management or trust relationships that give them fee-based revenue to offset the cheaper loan.

The specific linkage is against most banking regulations because a client may need a loan to save their business or other urgent need for liquidity more than they do other services and will go along with a less competitive total offering. This happens quite often and is used as leverage by the banks over clients.

However, there are many options now that allow clients to get the most favorable lenders that will compete for their business - while allowing them to keep their other relationships where they choose.

SILICON VALLEY BANK

The Silicon Valley Bank failure is notable not for the sophistication of the investment strategy that lost so much value - but in the simplicity of it.

They purchase TREASURIES that were mis-matched with their liabilities. Several weeks ago in our annual client letter, we spoke about how treasuries can be "nuclear weapons" in your portfolio, but we did not expect such a dramatic example to follow.

We also indicated that the Fed, led by Chairman Powell, would push rates higher to tame inflation until something broke - either the markets, the economy, housing or something unexpected. This banking crisis was an unexpected outcome due to the aggressive ratcheting up of rates.

Our sense is that the Fed is working right now to place Silicon Valley Bank in the hands of a big five national banks, and perhaps also working on a reserve fund to guarantee deposits so that runs on other banks do not overwhelm the system this week.

There are likely to be other unanticipated events this week - but the Fed should be able to stabilize the situation as the actual losses of Silicon Valley Bank were actually not that severe, and the real risk to the system is unnecessary depositor panic across the country. The banking system in general is in good capital position relative to most historical standards.

KEY TAKEAWAYS

1) Always diversify banking relationships to stay below the $250,000 FDIC coverage per account for deposit accounts.

2) Non-Banks have checking accounts that do the same thing without bank failure risk. And the rates are typically better.

3) You do not have to "consolidate your relationship" at a bank to have competitive loans and asset-based lending.

4) Silicon Valley Bank situation will likely be stabilized this week by the Fed.

5) There may be other unanticipated events that we will be watching closely.

Please contact us should you have any questions.