AMERICAN ECONOMIC LIBERTIES PROJECT

The Silicon Valley Bank Bailout: What You Need to Know

On March 12, the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve invoked emergency lending authority to backstop the debt of two large regional banks, Silicon Valley Bank and Signature Bank. In doing so, regulators and central bankers chose to give an implicit government guarantee for depositor losses of an entirely new class of banks.

This Quick Take will discuss what happened, why taxpayer money was used to shore up the creditors to these banks and will offer some suggested solutions. It will focus on Silicon Valley Bank, because the two banks have similar business models. It will also offer an analysis of broader potential losses in the banking system and situate the failures of SVB and Signature within the context of tightened financial conditions prompted by the inflation-fighting policies of the Federal Reserve.

What is Silicon Valley Bank? What is Signature Bank?

Silicon Valley Bank and Signature Bank are both financial institutions that primarily serve businesses and wealthy individuals, as opposed to ordinary citizens. Silicon Valley Bank, with $209 billion in assets, was until March 11th, 2023, the 16th largest bank in the United States, and was known for serving the founders of tech firms, as well as venture capitalists, premium

wineries, and private equity firms.[1] It financed nearly half of venture-backed technology and health care firms.[2] Signature Bank, with $110 billion of assets, was a politically connected bank that served private equity firms, law firms and the crypto world.[3]

In a well-regulated banking system, most banks generally do not experience bank runs. But both of these banks, as well as their customers, used irresponsible risk-management strategies, and the business models their own executives designed made them unusually vulnerable to bank runs.

Is My Bank Account at Risk?

No. Your deposits are insured by the FDIC up to the amount of $250,000 by the government, and most banks are well-capitalized. The FDIC outlines ways for larger depositors to legally expand coverage, and there are also private sector products to do so.[4]

What Is Deposit Insurance?

Deposit insurance is a government guarantee of the cash held in accounts below a certain amount, regardless of whether your bank has the cash available. The FDIC is a government insurance corporation and regulator that offers insurance for up to $250,000 to depositors in case the bank holding their funds cannot honor its obligations to insured depositors.

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[1] SVB Financial 10-K, 2022 https://d18rn0p25nwr6d.cloudfront.net/CIK-0000719739/f36fc4d7-9459-41d7-9e3d-2c468971b386.pdf FDIC Creates a Deposit Insurance National Bank of Santa Clara to Protect Insured Depositors of Silicon Valley Bank, Santa Clara, California, FDIC, March 10, 2023. https://www.fdic.gov/news/press-releases/2023/pr23016.html

[2] Is my money safe? How secure is the banking system? Your Silicon Valley Bank fallout questions, answered, Ramishah Maruf, CNN, March 14, 2023. https://www.cnn.com/2023/03/13/business/svb-fallout-consumer/index.html.

[3] Superintendent Adrienne A. Harris Announces New York Department of Financial Services Takes Possession of Signature Bank, NY State Department of Financial Services, March 12, 2023. https://www.dfs.ny.gov/reports_and_publications/press_releases/pr20230312#:~:text=Signature%20Bank%20is%20a%20New,as%20of%20December%2031%2C%202022. Risky Bet on Crypto and a Run on Deposits Tank Signature Bank, Matthew Goldstein and Emily Flitter, New York Times. March 12, 2023, https://www.nytimes.com/2023/03/12/business/signature-bank-collapse.html Joe Biden Comes to the Rescue of Trump's 'Go-to' Bank After SVB Collapse, Khaleda Rahman, Time Magazine, March 13, 2023. https://www.newsweek.com/joe-biden-comes-rescue-trumps-go-bank-svb-collapse-1787353.

[4] FDIC FAQs: https://edie.fdic.gov/fdic_info.html#06.

The FDIC was started during the Great Depression so that ordinary citizens wouldn't have to worry about their bank going under. Without FDIC insurance, depositors got nervous their bank is in trouble and would try to withdraw their funds from a bank. When everyone did this at the same time, a 'bank run' ensued, often causing even well-managed banks to fail. Such a bank could pay off depositors, just not all at once. Government-provided deposit insurance stopped bank runs because citizens knew they would never have to withdraw their deposits from a bank for fear they couldn't get their money.

All banks must carry FDIC insurance, for which they are charged a small assessment that goes into a fund managed by the FDIC, which is known as the Deposit Insurance Fund (DIF). When a bank goes under, the FDIC goes into the bank and works to make sure that insured depositors get quick access to their FDIC-insured money. The FDIC also works to sell off that bank or parts of that bank to other banks that are still solvent and operating. The FDIC is so good at its job that most people do not even realize their bank has gone under. The Deposit Insurance Fund itself is backstopped by taxpayer money in the form of working capital and a line of credit from the Treasury.[5]

FDIC insurance doesn't cover everyone, although every depositor with $250,000 or less is always completely covered. Businesses and municipalities need banking services too, and there are products that allow them to protect their deposits, such as 'cash sweeps' that let them automatically divide up deposits into FDIC-insured chunks, or buying short-term Treasury bills, which are safe cash-like assets.

The government also provides banks access to the Federal Reserve system. If there is an unusually large desire on the part of customers to withdraw cash, banks can borrow cash from the Fed secured against something of value, usually securities that banks have purchased or loans they have made. The FDIC and Federal Reserve provide a 'safety net' to banks.

This system is a good deal for depositors and especially bankers. Bankers get cheap government guaranteed deposits which they in turn lend it out at higher interest rates, making a nearly guaranteed profit. In return, bankers must accept oversight from government regulators to

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[5] FEDERAL DEPOSIT INSURANCE CORPORATION. STAFF PAPER. BUILDING CREDIBLE AND EFFECTIVE. DEPOSIT INSURANCE SYSTEMS. November 2016. Diane Ellis. See footnote on p. 7. https://www.fdic.gov/deposit/insurance/staff-paper-20161118.pdf.

make sure they aren't doing too much risk-taking with government-guaranteed financing. Banks often bristle at regulation, because it hinders their ability to take risks and make a bigger short-term profit. However, forgoing the ability to take some risks is required because the money these bankers are using to take such risks isn't theirs, it's their depositors, and behind them, the taxpayer via the FDIC.

What happened with Silicon Valley Bank?

SVB didn't work like a normal bank. Most of its depositors held far more than $250,000 in their bank accounts; Roku, for instance, had nearly $500 million, and billionaire Mark Cuban apparently had $8-10 million in there. As a result, 90-97% of its deposits were *uninsured.* And that means that SVB was almost entirely outside of the FDIC system. Moreover, SVB was taking significant risks with its uninsured depositor money and had direct investments in tech companies.

The business model of Silicon Valley Bank was to hold deposits at a low interest rate, and then buying long-dated bonds, securities that need to be held for longer but which pay out a higher interest rate. This in and of itself is not unusual, as nearly all banks do this. But as Bloomberg noted, SVB's portfolio was especially concentrated in these bonds, with securities making up 56% of SVB's assets vs 25% at Fifth Third and 28% at Bank of America.[6] For years, this 'bet' paid off, because interest rates stayed the same. And since the bank showed accounting profits, executives got paid a lot of money. But SVB didn't take measures to ensure it would be safe if these securities dropped in value, such as buying hedges, diversifying their holdings, or repositioning into shorter duration bonds. Indeed, in late 2020, the firm's management received recommendations to do so, but refused, because it would hinder the firm's profits.[7]

One important question is why anyone would hold large uninsured deposits at any bank, let alone one pursuing such a risky strategy. Indeed, there seems to be some basic cash management issues here. A corporate treasurer, such as that at Roku, would likely not put a half

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[6] Startup Bank Had a Startup Bank Run, Matt Levine, Bloomberg, March 10, 2023.
https://www.bloomberg.com/opinion/articles/2023-03-10/startup-bank-had-a-startup-bank-run.
[7] SVB Failure Sparks Blame Game Over Trump-Era Regulatory Rule, Jennifer Surane, Tracy Alloway and Katanga Johnson, Bloomberg, March 13. 2023.
https://www.bloomberg.com/news/articles/2023-03-13/svb-failure-sparks-blame-game-over-trump-era-regulatory-rollback?sref=frV97TwV

a billion dollars into an uninsured deposit, a naïve and reckless move, without an ancillary unstated benefit. One possible reason is that SVB was giving important Silicon Valley elites 'white glove' banking services, which is to say below cost mortgages and personal lines of credit. This may have encouraged executives at companies like Roku to give SVB access to huge unsecured sources of short-term funding, something they should not do as responsible stewards of company funds and employee payroll. Furthermore, because of a loophole in the banking law known as the "Volcker Rule," SVB had stakes through an affiliate in over 3,000 tech companies, so it had influence over how those firms directed deposits.[8]

SVB was also a powerful political actor. In 2018, the bank was a key lobbying force for a bill, the Economic Growth, Regulatory Relief, and Consumer Protection Act, that loosened requirements on banks with less than $700 billion in assets, which meant that it could take bigger risks.[9] Opponents of removing rules from the banking sector, such as Senator Elizabeth Warren, then-Fed Governor Lael Brainard, and former Treasury official Saule Omarova, understood and predicted problems from this deregulatory choice. But regional banks successfully lobbied Congress and the Trump administration.[10]

As a result of this legislative and regulatory choice, SVB loaded up on bonds that would fall in value if interest rates rose. When interest rates rose, SVB's assets fell in value such that they might not be able to cover the bank's short-term liabilities, which include customer deposits. This was despite a clean bill of health from discredited auditor KPMG just two weeks before the collapse.[11] As a result, nervous uninsured depositors, fearing their deposits were not safe, pulled

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[8] How Silicon Valley Bank Served the Tech Industry and Beyond, Michael Tobin and Hannah Miller, Bloomberg, March 10, 2023. https://www.bloomberg.com/news/articles/2023-03-10/silicon-valley-bank-the-investor-lender-networker-of-startups How Silicon Valley Turned on Silicon Valley Bank, Ben Foldy, Rachel Louise Ensign and Justin Baer March 13, 2023. https://www.wsj.com/articles/how-silicon-valley-turned-on-silicon-valley-bank-ee293ac9.

[9] Elizabeth Warren: Silicon Valley Bank Is Gone. We Know Who Is Responsible, Senator Elizabeth Warren, New York Times, March 13. 2023. https://www.nytimes.com/2023/03/13/opinion/elizabeth-warren-silicon-valley-bank.html.

[10] Two Dems Could Sabotage Bank Regulator Who Opposed Their Deregulatory Agenda, Lee Harris, November 22, 2021. The American Prospect, https://prospect.org/economy/two-dems-could-sabotage-bank-regulator-who-opposed-deregulatory-agenda/ Federal Reserve, Statement by Governor Lael Brainard on Federal Reserve Board finalizes rules that tailor its regulations for domestic and foreign banks to more closely match their risk profiles, October 10, 2019 https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20191010.htm.

[11] KPMG Gave SVB, Signature Bank Clean Bill of Health Weeks Before Collapse, Jonathan Weil and Jean Eaglesham, Wall Street Journal, March 13, 2023. https://www.wsj.com/articles/kpmg-faces-scrutiny-for-audits-of-svb-and-signature-bank-42dc49dd.

their cash from the bank and caused a bank run. As this bank run continued, and hours before it failed, SVB handed out bonuses to its team.[12] SVB, short of good assets, was unable to borrow money from other banks or the Fed, so the FDIC took it over in a bankruptcy-style process known as 'resolution.'[13] Thousands of businesses who bank at SVB were frozen out of their accounts and unable to make payroll, leading to panic.

What Did the Government Do as SVB Fell Apart?

When the FDIC takes over a bank, it must ensure that every insured depositor gets immediate access to his or her account, up to $250,000. The FDIC is also generally required to offer a 'least-cost resolution,' which is to say, it must choose the strategy that minimizes the costs borne by the Deposit Insurance Fund (DIF).

Normally "selling" the failed bank to a healthy bank – that is providing the acquiring bank with cash to assume the failed bank's assets, liabilities and obligations - is the least costly resolution transaction structure. But in a situation with a bank that has virtually no insured deposits, and thus very little liability for the government, the FDIC will just liquidate the bank. That is to say, the FDIC will set up a liquidation facility for SVB to sell off all of the bank's assets in a series of deals and auctions and then repay creditors as it received cash for those assets. This is what the FDIC started to do, until Sunday evening on March 12. Had this path continued, insured depositors would have had access to their money on Monday March 13 and uninsured depositors likely would have had access to the bulk of their deposits that same week. The remainder of uninsured deposits, minus a small haircut, would be made available in two to four months.[14]

Over the weekend, a variety of influential men, like venture capitalist David Sacks, billionaire Mark Cuban, financier Bill Ackman, and economist Larry Summers, argued that the collapse of

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[12] Silicon Valley Bank employees received bonuses hours before government takeover, Hugh Son, CNBC, March 11, 2023.
https://www.cnbc.com/2023/03/11/silicon-valley-bank-employees-received-bonuses-hours-before-takeover.html.
[13] FDIC Creates a Deposit Insurance National Bank of Santa Clara to Protect Insured Depositors of Silicon Valley Bank, Santa Clara, California, FDIC, March 10, 2023.
https://www.fdic.gov/news/press-releases/2023/pr23016.html.
[14] FDIC Creates a Deposit Insurance National Bank of Santa Clara to Protect Insured Depositors of Silicon Valley Bank, Santa Clara, California, FDIC, March 10, 2023.
https://www.fdic.gov/news/press-releases/2023/pr23016.html

this bank would lead to economy-wide consequences. They argued that we would face 'contagion,' where depositors might panic and withdraw their uninsured deposits from regional banks that were the same size as SVB, and put that money in the largest banks, such as JP Morgan or Bank of America, which are perceived to have an explicit "Too Big to Fail" government backstop.

There is substantial panic among banks. Regional bank stocks declined substantially on March 13th, 2023, the Monday after the SVB and Signature failed, as did bonds of such banks as Key Bank, US Bancorp, and First Republic. Some may fail. Yet, such panic is contrasted against a casual attitude among community bankers. As an official from the Independent Community Bankers Association noted on Monday, the ICBA had received very few questions or concerns.[15] "If you are a reporter working on this story, call some community bank CEOs," tweeted former *American Banker* reporter Rob Blackwell. "Ask them if they are seeing panic in the streets. They are not."[16]

In this fogged environment, the Federal Reserve, the Treasury Department, and the FDIC chose to invoke emergency authority to undertake a bailout of SVB's uninsured depositors.[17] The FDIC can, if the board of the Federal Reserve and the Treasury Secretary agree, invoke a 'systemic risk exception' to the least-cost resolution requirement, which provides the FDIC with broad authority to use the insurance fund in whatever way it sees fit. Such an exception can only be invoked if authorities believe that the collapse of a financial institution will cause widespread economic and financial harm. On March 12, the FDIC invoked this authority to guarantee the deposits of uninsured depositors at both SVB and Signature Bank. It will pay for any losses incurred by assessing the rest of the banking system. Regulators will wipe out stockholders, bondholders, and fire the management team, though it's unclear if bonuses will be 'clawed back.'

At the same time, the Federal Reserve, using its own emergency lending authority, offered below-market loans to any other bank that wishes to borrow from its facilities, backstopped by

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[15] https://twitter.com/WVBankerTim/status/1635354900623421441 "Very few questions or concerns. Just those few from the regular Doomsday preppers."
[16] https://twitter.com/robblackwellAB/status/1635324020076814468 "If you are a reporter working on this story, call some community bank CEOs. Ask them if they are seeing panic in the streets. They are not."
[17] Joint Statement by the Department of the Treasury, Federal Reserve, and FDIC, FDIC, March 12, 2023. https://www.fdic.gov/news/press-releases/2023/pr23017.html.

$25 billion of taxpayer funds.[18] In doing so, the Fed has made substantial emergency support available to the entire banking system. This set of bailouts were highly controversial, and important former regulators, such as FDIC Chair Sheila Bair, disagreed with the choice to backstop uninsured depositors.[19]

Was this a 'Bailout?'

Yes. "When you have people who were going to take losses and now they are not, they are being bailed out by somebody," said Morgan Ricks, a law professor and financial expert at Vanderbilt University.[20] To put it a different way, regulators just handed over the full faith and credit of the United States to regional bankers. This choice may or may not show up in the government balance sheet immediately, but the ability to borrow at low rates is immensely valuable.

There are multiple channels through which public benefits are being conferred on well-capitalized entities. One direct channel is that the Federal Reserve is offering below-market borrowing rates to all banks in the economy, and it is backstopped by taxpayer money. The reason for the fiscal backstop is because, technically, the Fed is prohibited from engaging in fiscal actions, aka spending money. Since the Treasury Department is guaranteeing losses via its FDIC backstop, the Fed is no longer on the hook. But that the Treasury is offering this guarantee shows that regulators understand this is a fiscal action requiring taxpayer money.

Another direct channel is through the FDIC. Uninsured depositors, many of whom benefitted from unfair below-market rate loans and credit products, were made whole despite the risk they chose to accept. Those depositors are being bailed out directly by the FDIC's deposit insurance fund. While the FDIC will assess the rest of the banking system to retroactively pay for any losses, banks may in turn raise fees or prices to consumers using their services. It is true that SVB shareholders, bondholders, and executives lost money in the resolution. But

[18] Federal Reserve Board announces it will make available additional funding to eligible depository institutions to help assure banks have the ability to meet the needs of all their depositors, Federal Reserve Board, March 12, 2023. https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm.
[19] US regulators are setting a dangerous precedent on SVB, Sheila Bair, Financial Times, March 14, 2023. https://www.ft.com/content/b860ebb6-f202-4ec6-a80c-8b1527c949f4.
[20] The Old Policy Issues Behind the New Banking Turmoil, John Cassidy, New Yorker, March 13, 2023. https://www.newyorker.com/news/our-columnists/the-old-policy-issues-behind-the-new-banking-turmoil.

executives made large sums of money for at least five years using their risky strategy, and that money will not be recouped. Neither will the below-cost quasi-bribes offered to SVB clients.

Indirect channels are far more significant. Other uninsured depositors at other banks with substantial assets are more likely to believe that they will be made whole in the event of a bank resolution. Similarly, equity holders and debt holders at all other banks with uninsured depositors will accrue an unfair gain, as their borrowing costs drop. From now on, it will be widely recognized that all bank deposits at banks above $100 billion in assets are de facto insured by the government, meaning that losses have broadly been socialized while gains have not.

So why do proponents say there was no bailout? In part, it's because regulators are offering misleading rhetoric about the costs of their actions. The FDIC, the Fed, and Treasury jointly stated that "no losses associated with the resolution of Silicon Valley Bank will be borne by the taxpayer." Many commentators are arguing that this was not a bailout. Such an argument is similar to arguing there was no bank bailout in 2008 because the Troubled Asset Relief Program, which is the $700 billion bailout bill approved by Congress in October of 2008, ultimately showed an accounting profit. It is a technicality bordering on deception.

Is Our Banking System Fragile?

Yes. While SVB and Signature are extreme examples, banks have broadly speaking suffered roughly $600 billion of losses in securities since the Federal Reserve began tightening financial conditions last year. These losses are matched against trillions of dollars of capital, so the system is far from insolvent. That said, more individual regional banks of a relatively large size may go under, especially those financed by uninsured deposits and subject to interest rate risk. A system where the 16th and 40th largest banks failing raises systemic concerns is on its face a weak system.

The Federal Reserve is charged with ensuring price stability, which is to say, fighting inflation. To fight inflation, the Fed may need to further tighten financial conditions, which is to say shrink its balance sheet and raise interest rates on overnight borrowing. That could have the

perverse effect of increasing capital losses in the banking system. The Fed may be faced with a choice of allowing inflation to accelerate or crashing the banking system.

What is the Policy Response?

The short-term policy response to the failure of SVB should include:

- An investigation of Silicon Valley Bank, Signature Bank, and the associated activities of stakeholders, such as the powerful venture capitalists who banked at these institutions and then demanded a bailout.
- A Congressional repeal of the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act.
- Clawbacks of executive compensation at SVB and Signature Banks.
- Investigations over insider trading possibilities by the Securities and Exchange Commission and the Department of Justice Criminal Division, given insider stock sales just weeks before the run on SVB.
- Loosening of capital requirements in the short-term to prevent a downward spiral among otherwise healthy banks.
- Assuming financial conditions continue to tighten, other parts of the government should inject capital into the banking system to resolve weak banks, and to hold assets until the immediate panic has abated. Such a package should have clawbacks and penalties for those who profited from excessive risk-taking.
- Continuing to encourage banks to borrow from the Federal Reserve to deal with sudden demands for cash, but only against good collateral.

More fundamentally, this backstop shows that banking is not a private business, but a public franchise from the state. Bankers are shielded from risk, making bets with taxpayer money and keeping the profits in the form of bonuses when they win, and leaving taxpayers with the losses when they lose. A longer-term policy response demands a restructuring of our banking system. Banks should simply be a lot less profitable. Much of the 'profit' that banks use for stock buybacks, executive compensation, and dividends is simply the income from excessive

risk-taking that is needed to buffer future losses when the downside of those risks are borne out. As such, policymakers should consider a variety of new rules for our public banking system:

- Move bank supervisory authority from the Federal Reserve to the FDIC.
- Create a permanent version of the FDIC's crisis-era "Temporary Liquidity Guarantee Program" to remove risk of loss from deposit accounts "commonly used to meet payroll and other business transaction purposes."[21][1]
- For banks with more than $100 billion in assets, increase liquidity requirements, ban stock buybacks, and impose executive compensation caps.
- Propose and finalize executive compensation rules for financial executives in Section 956 of Dodd-Frank.
- Have the Financial Stability Oversight Council begin proceedings to break up "Too Big to Fail" banks that have a competitive advantage due to their perceived government backstop.
- Close the loophole in the Volcker Rule allowing banks to engage in equity investments.
- Develop a public banking system for deposits that are purely for safekeeping of cash and payroll disbursements.
- Accelerate the development of the FedNow payments network.
- Appoint tough regulators like Saule Omarova to bank regulatory positions.
- Create a presumptive ban against bank mergers above $50 billion in assets in order to prevent banks from becoming large enough to present systemic risks. Include an emergency exception in case a quick sale is necessary during a bank run.

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[21] Temporary Liquidity Guarantee Program, FDIC
https://www.fdic.gov/regulations/resources/TLGP/index.html