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RUN on the BANK

How Banks Work

What Causes Banks to Fall

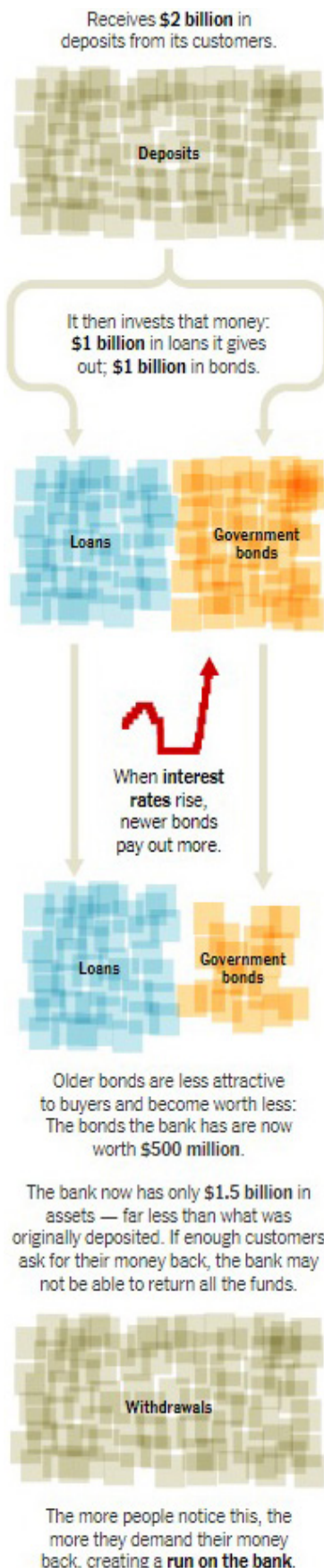
How the Government is Responding

How Bank and Brokerage Accounts May Be Protected

Dilemma for the Federal Reserve

There is nothing certain in life other than death, taxes, and that we try to explain complex financial concepts in layman terms.

In light of the sudden failure of Silicon Valley Bank, followed by the failure of Signature Bank of New York, and the teetering condition of a few other regional banks, we wanted to show how banks work, why they fail and how the government is responding. We explain in detail how bank and brokerage accounts may be protected by insurance. Finally, we discuss how the recent bank events cause a dilemma for the Federal Reserve regarding its goal to slow inflation.



How Banks Work

A bank takes deposits from its customers and lends those funds to people who want to buy a house or build their business.

To understand how a bank works, this picture from the New York Times, on March 18, 2023, is worth a thousand words.

Anatomy of a Bank Failure – Silicon Valley Bank (SVB)

Silicon bank was the premier bank to tech and biotech startups and had concentrated exposure to those customers. In 2020 and 2021, when the tech industry was booming, SVB's deposits grew very quickly – so quickly they were unable to lend the money out and instead bought large amounts of long-term government bonds and mortgage-backed securities. Because SVB bought these bonds when interest rates were very low, they took on significant interest rate risk in their portfolio.

All was good as long as SVB only had to pay their customers very low rates for deposits. The whole situation started to unravel when the Federal Reserve started raising interest rates in March 2022 leading to the following chain of events:

- Technology stocks fell in value and companies no longer issued stock to raise cash. So, instead of *growing*, SVB deposits *shrank* as companies used their available deposits to run their operations.
- Short term interest rates rose substantially thanks to the Fed, forcing SVB to pay their customers higher interest rates in order to keep their deposits.
- The value of SVB's long-term bond portfolio fell substantially as long-term interest rates went up. Bond prices go down as interest rates rise.
- SVB was forced to sell bonds (at a loss) to raise money that depositors requested. Once venture capital firms became aware of the losses, they told their startup companies who banked at SVB to take money out immediately.
- There was a run on the bank as too many customers withdrew their money at once (\$42 billion on Thursday, March 9, 2023!) before SVB could address the problem by raising more capital.

The outcome – the FDIC closed the bank on Friday, March 10, 2023 and on Monday, March 13, 2023 transferred all deposits to a full service 'bridge bank' that will be operated by the FDIC as it markets SVB to potential buyers. Many have asked where were the regulators? Interestingly, Gregory Becker, CEO of SVB until it failed, was quietly removed as a Director of the Federal Reserve of San Francisco on March 10, 2023.

What did Treasury Secretary Janet Yellen do in Response and Why?

After receiving recommendations from the FDIC, the Fed, and consulting with President Biden, Secretary Yellen approved actions allowing the FDIC to **fully protect** all depositors of SVB, not just protect the FDIC insured amounts of \$250,000. The rationale for going above the \$250,000 FDIC insurance amount is interesting. Because SVB held deposits for a large number of operating companies, the loss of funds or access to funds would wreak havoc with payroll and the other payments these companies need to make. This type of risk is considered systemic risk as the ramifications go well beyond the depositors. The Signature Bank failure on Sunday was also considered a systemic risk, and those depositors will be made whole as well. The determination of systemic risk is made for each bank separately, so it is not necessarily the case that all depositors of all banks will be protected on amounts over the \$250,000 FDIC insurance limit.

Is the Banking System at Risk?

Although the closure of SVB last week, and the way it happened will likely cause unintended consequences across a broad range of markets, businesses, and economies, the U.S. banking system will survive. It is at the heart of our economy, and the government will pull out all stops to halt a run on the banking system. Given that 43% of U.S. deposits are uninsured, the Federal Reserve undoubtedly will be and needs to be involved. Thus far, the Federal Reserve has taken action to shore up banks with funding issues. Specifically, "additional funding will be made available through the creation of a new Bank Term Funding Program (BTFP), offering loans of up to one year in length to banks, savings associations, credit unions, and other eligible depository institutions pledging U.S. Treasuries, agency debt and mortgage-backed securities, and other qualifying assets as collateral." These assets will be valued at par rather than the current (likely lower) fair market value, which is a big help to the banks that need to borrow.

How Are Your Bank and Brokerage Accounts Protected?

Bank Accounts

Certain amounts of your bank deposits are covered by the Federal Deposit Insurance Corporation (FDIC). The FDIC was created by Congress in 1933 during the Great Depression to maintain stability and public confidence in the U.S. financial system. The amount of FDIC insurance increased from \$100,000 to \$250,000 per ownership category (e.g., joint tenant, individual or IRA) in 2008 during the Great Recession. A lesser-known feature of FDIC insurance is that a POD (Payable on Death) bank account with beneficiaries can increase FDIC coverage. *Since coverage under FDIC is based on individual circumstances, you should consult with each individual financial institution to inquire about coverage amounts based on your specific deposit amounts and account types.*¹

¹ You may find more information regarding FDIC coverage at: https://www.fdic.gov/regulations/resources/brochures/your_insured_deposits-english.html.

To maintain high cash deposits, it may be prudent to:

- Spread the wealth among different banks to mitigate the concentration risk at a single bank that may experience distress.
- Have different types of accounts at any bank to ensure that your deposits are fully covered under FDIC rules for coverage (e.g., joint tenant, individual or IRA).
- Inquire with your financial institution/financial advisor to determine whether opening POD (Payable on Death) bank accounts make sense in your individual situation.
- Keep in mind, cash in money market mutual funds currently offers similar liquidity and much higher interest rates than bank deposits.

Brokerage Accounts

2X Wealth Group custodies our clients' accounts at Charles Schwab. For the purposes of this blog, we will use Charles Schwab as an example. Unlike accounts at a bank that are covered under FDIC insurance, securities accounts at broker dealers such as Schwab are covered by the **Securities Investor Protection Corporation (SIPC)** which provides protection for both securities and cash in client brokerage accounts.

- SIPC protections are activated in the rare event that the broker-dealer fails and client assets are missing due to fraud or other causes. According to SIPC, most broker-dealer failures happen with no securities missing. Since SIPC's inception over 50 years ago, 99% of eligible investors got their investments back in the failed brokerage firms cases that it has handled.
- SIPC coverage is used to make investors whole if there is a shortage after all customer assets held at the brokerage firm have been recovered. SIPC provides up to \$500,000 of protection for brokerage accounts held in each separate capacity (e.g., joint tenant, individual or IRA), with a limit of \$250,000 for claims of uninvested cash balances.
- Investments at Schwab are **segregated** at the broker/dealer which means these assets are separate and not commingled with assets at Schwab Bank.
- These **segregated assets** are protected against the broker/dealer creditors' claims.
- For cash held at Schwab Bank, clients have FDIC insurance up to the limit.
- Schwab has a very safe and liquid balance sheet.
- **In addition to SIPC, Schwab clients receive an extra level of coverage through "excess SIPC" insurance protection for securities and cash.** This helps ensure claims will be covered in the event of a brokerage firm failure and funds covered by SIPC protections are exhausted. The combined total of Schwab's SIPC coverage and Schwab's "excess SIPC" coverage means Schwab provides protection up to a combined return of \$149.5 million per customer, up to \$1.15 million of which may be in cash. The Excess SIPC program has a \$600M aggregate (meaning the most the program will pay for the Excess SIPC portion of the losses). Commodity interests and cash in futures accounts are not protected by SIPC.

The Federal Reserve Dilemma

As we look into the future, there is an inherent logical conflict between fighting inflation (taking money out of the system) on the one hand and essentially guaranteeing all the deposits of the U.S. banking system on the other (putting money into the system). As we have written and continue to believe, inflation will remain a problem. "The dramatic nature of SVB's collapse may give the Fed pause, but the facilities put in place to backstop depositors will likely make the Fed's job of reaching its 2% [inflation] target more difficult." (Strategas, 3/13/23) A recession, made all the more likely by current events, will curb inflation on the demand side, but structural supply constraints for essential commodities such as oil, metals and crops, and geopolitical concerns will keep the pressure on prices. As the dust settles, expect us to take advantage of opportunities presented as the baby gets thrown out with the bath water.

Need help sorting this all out? Make an appointment with us to help you through it.

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