

Memo to: Oaktree Clients  
From: Howard Marks  
Re: Lessons from Silicon Valley Bank

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This isn't going to be another history of the meltdown of Silicon Valley Bank. Dozens of those have appeared in my inbox over the past month, as I'm sure they have in yours. Thus, rather than merely recount the developments, I'm going to discuss their significance.

My sense is that the significance of the failure of SVB (and Signature Bank) is less that it portends additional bank failures and more that it may amplify preexisting wariness among investors and lenders, leading to further credit tightening and additional pain across a range of industries and sectors.

### One-off or a Harbinger of Things to Come?

A number of things about SVB made it somewhat of a special case – which means it probably won't turn out to be the first of many:

- The bank's business was heavily concentrated in a single sector – venture capital-backed startups in tech and healthcare – and a single region – Northern California. Many regional banks' businesses are similarly concentrated, but not usually in sectors and regions that are both highly volatile.
- The boom in its sector and region caused SVB's business to grow very rapidly.
- In recent years, startups were a major destination for investors' cash, a good deal of which they deposited at SVB. This caused SVB's deposits to triple, from \$62 billion at the end of 2019 to \$189 billion at the end of 2021.
- For the same reason, many of SVB's clients had so much capital that they had little need to borrow. As deposits piled up at SVB, there wasn't offsetting demand for loans. Few other banks have customers with similar cash inflows and consequently so little need to borrow money.
- Because SVB had few traditional banking uses for the cash that piled up, it instead invested \$91 billion in Treasury bonds and U.S. government agency mortgage-backed securities between 2020 and 2021. This brought SVB's investments to roughly half its total assets. (At the average bank, that figure is about one-quarter.)
- Presumably to maximize yield – and thus the bank's earnings – in what was a low-return environment, SVB bought securities with long-dated maturities. SVB designated these securities as "hold to maturity" (HTM) assets, meaning they wouldn't be marked to market on the bank's balance sheet since it had no intention of selling them.
- When the Federal Reserve embarked on its program of interest rate increases last year, bond prices fell rapidly, and, of course, the longer the tenor of the bonds, the greater the decline in value. In short order, the market value of SVB's bond holdings was down \$21 billion.
- Word of the bank's losses caused depositors to start withdrawing their money. To meet the withdrawals, SVB had to sell bonds. Consequently, the bonds could no longer be considered HTM. Instead, they had to be categorized as "available for sale" (AFS), meaning (a) the bonds were marked down on SVB's financial statements and (b) actual sales caused the losses to be crystalized.

- The recognized losses helped hasten the spread of negative rumors throughout the tight-knit venture capital community, which led to further withdrawals. An unusually large percentage of SVB's deposits – 94% – exceeded \$250,000 and thus weren't fully insured by the FDIC. This meant they were more “institutional” than “retail.” Additionally, SVB's customers were highly interconnected: They had many backers in common, lived and worked near each other, and could exchange information almost instantaneously through social media.

The sum of the above rendered SVB particularly vulnerable to a bank run if adverse circumstances developed – and they did. However, many of the above factors were peculiar to SVB. Thus, I don't think SVB's failure suggests problems are widespread in the U.S. banking system.

### What Did SVB Have in Common with Other Banks?

I talked above about some things that distinguished SVB from other banks. But it's as important to consider the elements they shared:

- Asset/liability mismatch – **Financial mismatches are dangerous, and banks are built on them.** Deposits are banks' primary source of funds, and while some have longer terms, most can be withdrawn on any day, without prior notice. On the other hand, making loans represents banks' main use of funds, and most loans have lives ranging from one year (commercial loans) up to 10-30 years (mortgages). So, while most depositors can demand their money back at any time, (a) no banks keep enough cash on hand to pay back all their depositors, (b) their main assets don't pay down in a short timeframe, and (c) if they need cash, it can take them a long time to sell loans – especially if they want a price close to par. Maintaining solvency requires bank managements to be aware of the riskiness of the assets they acquire, among other things. But liquidity is a more transient quality. **By definition, no bank can have enough liquidity to meet its needs if enough depositors ask for their money all at once.** Managing these issues is a serious task, since it's a bank's job to borrow short (from its depositors) and lend long.

This mismatch, like most other mismatches, is encouraged by the upward slope of the typical yield curve. If you want to borrow, you'll find the lowest interest rates at the “short end” of the curve. Thus, you minimize your costs by borrowing for a day or a month . . . **but you expose yourself to the risk of rising interest expense, since you haven't fixed your rate for long.** Similarly, if you want to lend (or invest in bonds), you maximize your interest income by lending long . . . **but that subjects you to the risk of capital losses if interest rates rise.** If you follow the yield curve's dictates, you'll always borrow short and lend long, exposing you to the possibility of an SVB-type mismatch.

- High leverage – Banks operate with skinny returns on assets. They pay depositors (or the Fed) a low rate of interest to borrow the funds they need to operate, and they lend or invest those funds at slightly higher rates, earning a modest spread. But they literally make it up on volume. They employ heavy leverage, meaning they can do a lot of business based on little equity capital, thereby translating a low return on assets into a high return on equity. However, having a high ratio of total assets to equity capital means a modest decline in asset prices can wipe out a bank's equity, rendering it insolvent. **There's no source of meltdown – in any sector – as potentially toxic as the combination of high leverage and an asset/liability mismatch.** Banks have them both.

- Reliance on trust – Since depositors put money in banks in pursuit of safety and liquidity and, in exchange, accept a low return, faith in banks’ ability to meet withdrawals is obviously paramount. Depositors ostensibly can get liquidity, safekeeping, and low interest from any bank – that is, one bank’s offering is essentially undifferentiated from those of others. Thus, most depositors are perfectly willing to change banks if given the slightest reason, and there’s no offsetting reason for them to leave their money on deposit if a bank’s safety is questioned.

You may be familiar with one of my favorite sayings: “Never forget the six-foot-tall person who drowned crossing the stream that was five feet deep on average.” **Surviving on average is a useless concept; you have to be able to survive all the time, including – no, especially – in bad times.** Borrowing short to invest long powerfully threatens that ability. Being highly levered is another reason why, metaphorically, tall people sometimes drown in streams that are shallow on average. And for financial institutions, customers’ loss of confidence is a third.

**The bottom line is that banks are, essentially, highly levered fixed income investors.** Any long-term, fixed-rate loans or bonds they own (which for most banks aren’t a large percentage of total assets) are subject to declines in economic value in a rising-interest-rate environment. Banks don’t have to recognize price declines on assets they intend to hold to maturity, but any bank that is forced to sell those assets to meet withdrawals would have to show the declines on its financial statements.

Looked at this way, retaining depositors’ trust is an absolutely essential ingredient in a bank’s activities, and that means assets, liabilities, liquidity, and capital have to be skillfully managed. In SVB’s case, its equity went up in smoke when rising interest rates reduced the value of a good part of its assets.

In that vein, I’m going to share a personal anecdote. When our son, Andrew, went off to college in 2005, Nancy and I concluded it would be great to live outside the United States for a while, something neither of us had ever done. We chose to live in the UK for four months of the year, during which I worked in Oaktree’s London office. To generate income to cover our living expenses, we moved cash to a UK bank and asked that it be deposited in CDs at several building societies (what we in the U.S. call savings & loans). One of those was Northern Rock. In September 2007, as the financial crisis was brewing, Northern Rock had trouble securing the financing it needed in the wholesale funding market on which it traditionally had depended. That prompted depositors to queue up to close their accounts.

I called my banker on a Friday afternoon to ask whether I could move my funds elsewhere, and he told me there would be a 2% penalty for early withdrawal. It took me about one second to say, “please move those funds first thing Monday morning.” A 2% penalty sounded like peanuts relative to risking my entire principal at Northern Rock. Now imagine the thinking of SVB depositors who could withdraw their money without any penalty. (As it happens, the UK government guaranteed Northern Rock’s deposits over the weekend in question, eliminating the need to move the funds. But that was my closest brush with a bank failure.)

Another new trend that has added to banks’ precariousness is the emergence of digital communications, including social media. Sixteen years ago, it took days for Northern Rock’s depositors to become aware of its difficulties. And when they decided to move their money, they had to go to their branch during banking hours (what a quaint notion), queue up, and submit a withdrawal request. In SVB’s case, word of the bond losses traveled quickly, through unusually interconnected depositors who had the ability to request withdrawals online. As a result, more than one-third of the bank’s deposits departed in a single day. All banks have to contend with digital communication and online withdrawals these days, but SVB’s depositors were particularly high flight risks, given the bank’s region and the nature of its clientele.

About twenty years ago, my partner Sheldon Stone shared an interesting parable: Imagine you're on a boat crossing Lake Erie. The captain comes on the loudspeaker and says, "Everyone run to the left side of the boat." A minute later he says, "Everyone run to the right side." And a minute after that he says, "Run back to the left." It would make for an unusually rocky crossing. Today the internet and social media are the loudspeaker, which almost anyone can take over, disseminating any message they choose. This "digital herding," as Gillian Tett of *The Financial Times* has labeled it, can have a huge impact in many fields, particularly those that run on information and trust.

### Was SVB's Collapse Inevitable?

To close the loop, I'm going to recap the interrelated factors that caused SVB to fail:

- If the bank had made more loans relative to the size of its deposit base, it wouldn't have bought as many potentially volatile bonds.
- If the bonds the bank bought hadn't had such long maturities, it wouldn't have been as exposed to price declines.
- If the Fed hadn't raised interest rates as much as it did, the bonds wouldn't have lost so much value.
- If the depositors hadn't exited en masse, the bank wouldn't have had to sell bonds and realize the losses.

You wouldn't think a portfolio consisting of bank loans and high-quality Treasury and mortgage-backed bonds could be vulnerable to a meltdown that would render a bank insolvent. But the scale of SVB's bond investments, the length of the maturities, and the extent of the Fed's interest rate hikes put SVB at risk, and the rapidity of the withdrawals caused the problem to run far ahead of the solutions.

When looking at SVB's demise, the decision-making behind its bond purchases stands out as particularly flawed and probably the primary cause of the bank's failure. According to public reports, SVB management "made a bet" that interest rates would hold steady or fall. While that expectation is implicit in its actions, I find it hard to believe it was a conscious, considered decision, as opposed to an example of mindlessly chasing yield, perhaps abetted by wishful thinking. The bond purchases took place in 2020 and 2021. In that two-year period, the yield on the 30-year Treasury ranged between 0.99% and 2.45%. How could anyone have thought rates that low were more likely to hold steady or fall than rise? Determining how to move forward is always challenging in economics and investing. However, when the Fed and Treasury flooded the economy with cash in 2020 and inflation began to rise in 2021, **the one thing that should have been obvious was that there was no good reason to hold long-dated bonds at pitifully low yields, which presented profound risk and miniscule potential for return.**

### Comparisons to the GFC

SVB's failure – along with the collapse of Signature Bank, the rescue of First Republic Bank, and Credit Suisse's forced sale to UBS – roiled markets in March. This resulted from fear of bank failure contagion along the lines of what we saw during the Global Financial Crisis of 2007-08, when Bear Stearns, Merrill Lynch, Lehman Brothers, Wachovia Bank, Washington Mutual, and AIG either melted down or required rescues. There were times in that span, particularly in the last four months of 2008, when investors were forced to contemplate the possibility of an unstoppable series of failures that could have endangered the entire financial system. Nobody wants to face that again.

**While I want to state clearly that I'm not an expert on banks or their regulation, I think the similarities between 2008 and 2023 are limited to the mere fact that, in both instances, problems existed at a few financial institutions.** I find the common elements mostly superficial. What follows are the differences.

By far most importantly, the GFC occurred for the simple reason that investors and financial institutions experienced temporary insanity with respect to residential mortgages. They:

- accepted unquestioningly that mortgages' low-default history could be extrapolated;
- forced massive amounts of money into the mortgage market;
- loaned lots of it to subprime borrowers who couldn't or wouldn't document income or assets;
- built tranching and levered mortgage-backed securities using subprime mortgages; and
- in many cases, invested their own capital in the riskiest tranches of the RMBS to enable the formation process to be repeated.

These parties ignored the possibility that excessive faith in mortgages – and the resultant lowering of lending standards – could precipitate massive numbers of mortgage defaults. Further, they ignored the fragility of the structured securities built out of those mortgages. Investors, bankers, and rating agencies (which awarded AAA ratings to thousands of RMBS issues) naively trusted that people who were willing to pay extra interest to obtain mortgages without disclosing their financial condition would repay those mortgages, even if the prices of the homes they bought fell. This led them to conclude that mortgage defaults wouldn't be sufficient to jeopardize the mortgage-backed securities' viability. Subprime mortgages were totally lacking in substance, yet many of the world's leading financial institutions were happy to make those loans and invest in securities built out of them.

**Looking at the current situation, I can't think of anything that's highly analogous to the subprime mortgages at the heart of the GFC.** There are things here or there that have been over-hyped or are short on substance – some people will point to SPACs or cryptocurrencies – but they're not as massive in scale, perhaps not as lacking in substance, and certainly not held on the balance sheets of America's key financial institutions in amounts sufficient to endanger our financial system. **Indeed, I think it's safe to say the most glaring market excesses were corrected in 2022 and aren't hanging over us now. (However, for a caveat, please see this memo's last few paragraphs.)**

In addition, whereas the list of institutions that disappeared during the GFC included some that clearly were systemically important, I don't think that can be said of SVB. I doubt our financial system was highly reliant on promises made by SVB and thus subject to extensive counterparty risk. The GFC affected some truly large banks – household names – and most people believed it was on the way to jeopardizing even bigger ones before the government stepped in. There's no reason to think the failure of SVB poses the same risk.

Finally, it should be borne in mind that even though huge banks appeared to be endangered in 2008, **the Fed and other economic policymakers were able to come up with rescue plans** (for the institutions and for the economy), **and they worked!** In that vein, it's worth noting that the Fed's response to SVB's problems included (a) guaranteeing all SVB deposits, (b) making additional liquidity available to banks, (c) injecting extensive liquidity into the economy, and (d) letting its balance sheet grow, even though it's been in the process of winding it down from its post-pandemic high. Thus, I find it hard to believe that SVB or the like can set off a chain reaction sufficient to trigger an irreversible financial crisis.

On the subject of the problem's scale, I want to mention a new pet peeve of mine. Increasingly, we hear the media say things like, “this was the best month in the stock market since 2020” or “we saw more new

daily lows today than on any day since October.” The media like this kind of dramatic-sounding comparison, and the latest is that “SVB is the biggest bank to fail since the GFC.” But these comparisons don’t always mean much. In the case of SVB, it should be noted that, while this is the second-biggest bank failure in history, SVB was only two-thirds the size of Washington Mutual, the biggest. Further, since the financial sector has expanded meaningfully in the last 15 years, WaMu’s \$307 billion of assets in 2008 were much more significant than SVB’s \$209 billion today.

### A Word on Regulation

In March 2011, in the aftermath of the GFC, I published a memo called *On Regulation*. Its basic thrust was that financial regulation is highly cyclical. Crashes, meltdowns, and widespread misbehavior bring on calls for increased regulation. They also make increased regulation palatable to most parties. But when the new regulations succeed – and thus appear to make the financial environment safer and better functioning – free marketeers and people with vested interests typically start to argue that such strong regulation is no longer necessary and that it restricts the financial system’s effectiveness. For example, in response to the Great Crash of 1929, massive new regulations were enacted between 1930 and 1940 to constrain conduct in the wild, wild west of Wall Street. But by the 1990s, the pain of the Crash was long forgotten, and belief in the efficacy of the free market was riding high. As a result, multiple regulations were dismantled, enabling conduct that contributed to very painful experiences in the GFC.

The GFC, in turn, inspired another round of regulation. One of the governing principles was that financial institutions that are too big to fail – and thus will, by necessity, be bailed out if threatened – shouldn’t be permitted to engage in risky activities, as this creates a situation where “heads, the shareholders and management win; tails, the taxpayers lose.” That proposition seems reasonable on its face and was implemented via the Dodd-Frank Act and its Volcker Rule. In general, bank regulation was significantly tightened.

As time passed, the normal pushback against regulation emerged. The aspect that’s most relevant here is the regulatory threshold. Following the GFC, all banks with assets above \$50 billion were subject to the strictest standards. But in 2018, regulators were convinced to raise that figure to \$250 billion (thanks in part to the lobbying of SVB’s chief executive officer). As a result, SVB – with assets around \$50 billion at the time the threshold was raised – faced a looser regulatory regime. This helped it expand massively – until it failed in a matter of days.

Nevertheless, thanks to the post-GFC rules, the major U.S. banks today are well capitalized and have significant liquidity and healthy balance sheets. This makes it less likely that we’ll see a GFC-type round of bank failures. I’ve heard it argued that current regulations and the resultant financial condition of banks aren’t robust enough, but I believe most banks – and especially the majors – are much stronger than they were before and during the GFC and typically much stronger than SVB.

Interestingly, Canada, Australia, and Britain function very well with far fewer banks than the U.S. Canada, for example, has \$2 trillion of GDP and just 34 domestic banks (17 per \$1 trillion of GDP), and it seems to get by. In contrast, in 2021, the U.S. had 4,236 FDIC-insured commercial banks for its \$20 trillion of GDP, or 212 banks per \$1 trillion. Could regulators do a better job if there were fewer banks to monitor? We’ll see what happens to the number of U.S. banks if big ones absorb smaller ones and deposits become concentrated in the bigger ones. But given the role of private parties and their money in our system of government, I don’t expect to see a major change.

## Moral Hazard

One problem with government solutions of any kind – like the so-called “Greenspan put” – is the possibility that they’ll generate moral hazard. That is, players will conclude that they’ll be rescued if they make a mistake. This suggests they can freely engage in high-risk, high-return behavior; if it works, they’ll get rich, but if it fails, they’ll be bailed out. People sometimes refer to this as “privatizing profits and socializing losses.”

On March 9, when SVB was hanging by a thread while experiencing massive withdrawals, people started talking about a possible government guarantee of all deposits. One of the arguments against such a bailout was that it would create moral hazard. If people know they’ll be protected from losses, they’ll have no reason to examine the solidity of a bank before depositing money, meaning the diligence function won’t be performed. Consequently, poorly run, poorly capitalized banks will be permitted to stay in business and grow.

**But we simply cannot expect depositors to perform that function.** Since banks’ operations are characterized by mismatched assets/liabilities and a dependence on depositors’ trust, it’s terribly hard to assess their financial health from the outside (maybe sometimes from the inside, too, since SVB succumbed to what in retrospect seem to have been obvious managerial mistakes). In the 28 years that Oaktree has been in business, we’ve invested in relatively few deposit-taking financial institutions. Other than in cases where we’ve become insiders, we’ve generally avoided investing in banks because their complex, often impenetrable financial disclosures and reliance on trust make them harder to evaluate than we like.

Few people are capable of studying banks’ financial statements and determining whether they’ll remain solvent and liquid. **Expecting depositors to do so could cause banking to grind to a halt.** That’s why deposit insurance was introduced during the Great Depression. For the same reason, the government’s decision to fully guarantee SVB’s deposits was quite appropriate.

Notably, however, management and shareholders weren’t bailed out; rather, in today’s parlance, they were “bailed in,” or left with their losses. We can hope their losses will encourage other investors and bank managers to apply greater prudence in their future decision-making.

## AT1s

While not at all related, SVB’s failure gives me a chance to discuss another topic involving financial institutions that’s recently been in the news: Additional Tier 1 bonds, or AT1s. On the heels of the GFC, European regulators required banks to raise new equity capital (“tier 1 capital”) and delever. However, given the risks surrounding the banks, potential providers of capital demanded inducements. With AT1s, these came in the form of bond-like yields, a promise of repayment at maturity, and debtholder status. So far, so good.

In UBS’s recent takeover/rescue of Credit Suisse, FINMA, the Swiss bank regulator, determined that (a) shareholders would receive modest compensation and (b) the holders of the \$17 billion of AT1s would get nothing. There was an immediate outcry, along with threats of litigation.

Although AT1s are clothed as debt securities, it seems FINMA had the power to alter the AT1s’ priority relative to the shareholders and even eliminate their value. In this case, they chose to put the AT1s behind the shareholders, wiping out investors who thought they were creditors. As *Bloomberg* noted on March 23, this shouldn’t have come as a surprise:

A prospectus for the Credit Suisse AT1s highlights from the very first page the possibility of a wipeout when there is what's known as a writedown event. In this scenario, interest on the notes would stop accruing and the full outstanding amount of the bonds would be automatically and permanently written down to zero. Finma has the power to decide that a type of writedown event known as a "viability event" has occurred if a bank's efforts to improve capital adequacy are "inadequate or unfeasible," or if there is "extraordinary public support" to avoid a bankruptcy, insolvency or halt to regular business.

*Bloomberg's* Matt Levine explained how this worked in Credit Suisse's case:

If the bank's common equity tier 1 capital ratio – a measure of its regulatory capital – falls below 7%, then the AT1 is *written down to zero*: It never needs to be paid back; it just goes away completely. . . .

**These securities are, basically, a trick.** To *investors*, they seem like bonds: They pay interest, get paid back in five years, feel pretty safe. To *regulators*, they seem like equity: If the bank runs into trouble, it can raise capital by zeroing the AT1s. **If investors think they are bonds and regulators think they are equity, somebody is wrong. The investors are wrong.**

In particular, investors seem to think that AT1s are *senior* to equity, and that the common stock needs to go to zero before the AT1s suffer any losses. But this is not quite right. You can tell because **the whole point of the AT1s is that they go to zero if the common equity tier 1 capital ratio falls below 7%.** (*Bloomberg Opinion; Money Stuff*, March 20, 2023. Bolding added.)

Were the investors misled? To me, the answer is no. In this regard, let's consider the way the prospectus for one such Credit Suisse issuance – "a \$2 billion US dollar 7.5% AT1 issued in 2018" – was labeled (per Matt Levine): "7.500 per cent. Perpetual Tier 1 Contingent Write-down Capital Notes." There shouldn't have been much doubt about their riskiness when "write-down capital notes" was in the title.

I once wrote of Bernie Madoff that you can say you did thorough due diligence or you can say he passed the test, but you can't say you did thorough due diligence and he passed the test. Likewise, in the case of Credit Suisse's AT1s, you can say you read and understood the prospectus, or you can say you thought they were like ordinary debt securities, but you can't say both.

Maybe there's a third path; maybe you could say "I knew the regulators had the power to zero me out, but I didn't think they ever would." **It seems to me that if people can take value from you legally, and especially if doing so isn't unambiguously immoral, you shouldn't be surprised if they do.** Holders of high yield bonds have for many years dealt with an analogous phenomenon called "event risk," which refers to actions undertaken by company management for the purpose of transferring value from bondholders to stockholders. In the case of Credit Suisse, the regulators likely gained the cooperation of shareholders by paying them a few francs per share while wiping out the AT1s. Under the circumstances, that shouldn't have come as a complete surprise. **It's all part of protecting banks, which – as noted above – are risky by nature.**

### Psychological Ramifications of the SVB Collapse

As I previously mentioned, I don't view SVB, Signature Bank, First Republic, and Credit Suisse as having been connected other than by the fact that they were in the same general line of work. That did



give them one thing in common: Since they're all financial institutions, events involving them can broadly impact depositors' and investors' confidence (or lack thereof). People seem to have trouble dealing with multiple problems at once, and the near-simultaneous challenges at four banks caused people to string them all together like beads, crafting a narrative that included a potential systemic meltdown.

While they don't seem to me to be connected in tangible ways, the four banks' recent crises certainly had the power to shake things up. And when participants in the economy or market are shaken up, the implications can be serious. As President Franklin D. Roosevelt said in his 1933 inaugural address during the Great Depression, **“the only thing we have to fear is fear itself.”** Things don't have to be connected physically or even economically. In the markets, a series of scary events can have a very powerful impact.

The credit crises during which my partners and I have invested over the last 38 years generally have resulted from some combination of (a) negative economic developments, (b) excesses in the markets, (c) adverse exogenous events, and (d) rising fear among investors and finance industry professionals. The failures of SVB and the other banks likely aren't enough to bring on a credit crisis, but they could contribute to one. As a result, it seems inescapable that some financial institutions will reduce the amount of credit they make available, causing some borrowers to be left out. In particular, SVB's failure could mean the startup world will have a tougher time getting financing in the months ahead. Regional and community banks are likely to undergo increased scrutiny and experience deposit flight as cash flows to money market funds and larger banks perceived to be safer. Their importance as the main financers of real estate makes it likely that the going will get tougher for property owners and developers, just as office buildings, brick-and-mortar retail, and perhaps even multifamily are coming under pressure in many regions.

Combine developments like these with the reality that (a) interest rates are no longer declining or near zero; (b) the Fed can't be as accommodative as it was in the last few crises, because of today's elevated inflation; and (c) negative developments are popping up in portfolios, and I think the case made in my previous memo, *Sea Change* (December 2022), has been bolstered. The easy-money environment of the last few years has been blamed for – among other things – the difficulties at SVB and its peers. Their failure is likely to bring stricter scrutiny to banking, meaning things are unlikely to be as easy in the period ahead. And to paraphrase Warren Buffett, now that the tide has gone out a bit, we've caught a glimpse of some who were swimming naked near shore. The remaining questions are, how many more are out there, and will the tide go out far enough to expose them?

**When investors think things are flawless, optimism rides high and good buys can be hard to find. But when psychology swings in the direction of hopelessness, it becomes reasonable to believe that bargain hunters and providers of capital will be holding the better cards and will have opportunities for better returns. We consider the meltdown of SVB an early step in that direction.**

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**While I don't foresee widespread contagion – either psychological or financial – arising from the SVB failure alone, I can't end a memo on U.S. banks without mentioning one of the biggest worries they face today: the possibility of problems stemming from loans against commercial real estate (“CRE”), especially office buildings.**

The following factors are influencing the CRE sector today:

- Interest rates are up substantially. While some borrowers benefit from having fixed interest rates, roughly 40% of all CRE mortgages will need to be refinanced by the end of 2025, and in the case of fixed-rate loans, presumably at higher rates.
- Higher interest rates call for higher demanded capitalization rates (the ratio of a property's net operating income to its price), which will cause most real estate prices to fall.
- The possibility of a recession bodes ill for rental rates and occupancy, and thus for landlords' income.
- Credit is likely to be generally less available in the coming year or so.
- The concept of people occupying desks in office buildings five days a week is in question, threatening landlords' underlying business model. While workers may spend more time in the office in the future, no one knows what occupancy levels lenders will assume in their refinancing calculations.

Total U.S. bank assets exceed \$23 trillion. Banks collectively are the biggest real estate lenders, and while we only have rough ranges for the data, they're estimated to hold about 40% of the \$4.5 trillion of CRE mortgages outstanding, or around \$1.8 trillion at face value. Based on these estimates, CRE loans represent approximately 8-9% of the average bank's assets, a percentage that is significant but not overwhelming. (Total exposure to CRE may be higher, however, as any investments in commercial mortgage-backed securities have to be considered in addition to banks' holdings of direct CRE loans.)

However, CRE loans aren't spread evenly among banks: Some banks concentrate on parts of the country where real estate markets were "hotter" and thus could see bigger percentage declines; some loaned against lower-quality properties, which is where the biggest problems are likely to show up; some provided mortgages at higher loan-to-value ratios; and some have a higher percentage of their assets in CRE loans. To this latter point, a recent report from Bank of America indicates that average CRE loan exposure is just 4.5% of total assets at banks with more than \$250 billion of assets, while it's 11.4% at banks with less than \$250 billion of assets.

Since banks are so highly levered, with collective equity capital of just \$2.2 trillion (roughly 9% of total assets), the estimated amount the average bank has in CRE loans is equal to approximately 100% of its capital. Thus, losses on CRE mortgages in the average loan book could wipe out an equivalent percentage of the average bank's capital, leaving the bank undercapitalized. As the BofA report notes, the average large bank has 50% of its risk-based capital in CRE loans, while for smaller banks that figure is 167%.

Notable defaults on office building mortgages and other CRE loans are highly likely to occur. Some already have. But that doesn't necessarily mean the banks involved will suffer losses. If loans were made at reasonable LTV ratios, there could be enough owners' equity beneath each mortgage to absorb losses before the banks' loans are jeopardized. Further, mortgage defaults generally don't signal the end of the story, but rather the beginning of negotiations between lenders and landlords. In many cases, the result is likely to be extension of the loan on restructured terms.

**No one knows whether banks will suffer losses on their commercial real estate loans, or what the magnitude will be. But we're very likely to see mortgage defaults in the headlines, and at a minimum, this may spook lenders, throw sand into the gears of the financing and refinancing processes, and further contribute to a sense of heightened risk.** Developments along these lines certainly have the potential to add to whatever additional distress materializes in the months ahead.

April 17, 2023

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