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A NOTE ON MORAL HAZARD AND BANK FAILURES

Sean Abbey, CFA

The failures of Silicon Valley Bank (SVB) and Signature Bank were dramatic given the speed of the deposit flight from these institutions. Liquidity risk is an endemic feature of the fractional reserve banking system and is a risk that can only be managed not eliminated. In a simplistic view of a bank's balance sheet, the investment portfolio is meant to serve as a source of liquidity to meet among other things, withdrawal demands.

A bank's loan portfolio is comprised of relatively illiquid assets (loans) that cannot easily be sold to generate cash and the investment portfolio is a buffer so to speak to allow a bank to meet unexpected liquidity needs. Occasionally, bank management teams become attracted to the idea of allocating a bank's investment portfolio into higher yielding fixed income securities to improve the return on equity of the overall bank. This temptation was particularly acute since the Great Financial Crisis (GFC) with rates held at or near zero for much of this period. Unfortunately for bank management teams, fixed income instruments with higher yields typically came with higher duration and in certain securitized instruments like residential and commercial MBS, negative convexity profiles. The trade-off for this yield seeking behavior was higher yields in return for accepting more interest rate risk. The impact to a security's value due to changes in interest rates and the shape of the yield curve is a relatively mechanical relationship (note: *technically, modeling convexity is somewhat of an estimate due to having to model the behavior of underlying borrowers as rates and economic conditions change*) that is understandable, at least directionally, at the time the manager purchases the fixed income instrument for the bank's portfolio.

Accepting an above average amount of interest rate risk is essentially a bet made by the bank's management team on the direction of future interest rates and the shape of the yield curve. Interest rate risk can be somewhat managed synthetically with swaps and other derivatives, but there is a hard cost to this in transaction fees, bid-ask spreads, and reporting needs as well as indirect costs with increased complexity and reliance on your broker-dealer to provide fair pricing of these instruments.