Private Credit Views

March 2023

Market Reflections & Outlook

Crisis of Confidence: U.S. Banking System Under Fire

Reasons behind the collapse of Silicon Valley Bank (SVB) and Signature Bank and the ensuing crisis of confidence will likely be debated for years to come. No doubt, with the benefit of hindsight, pundits will argue that the events were entirely predictable and avoidable. It will certainly be hard to argue how the combination of (i) years of accommodative monetary policy; (ii) a pandemic that largely shut down the global economy; (iii) a protracted ground war in continental Europe; and (iv) central banks rapidly raising interest rates to temper inflation resulting from all of the above would not result in something breaking. The jury is out on whether government intervention will be sufficient to restore faith in regional banks and the distributed banking model that underpins the U.S. financial system, but it may be worth reflecting on what can be learned from the events and how it might impact direct lending markets.

Four interrelated leading contenders for lessons learned or, maybe more appropriately, lessons *relearned* may include: (1) the risks associated with asset and liability duration mismatches; (2) the importance of risk management; (3) the power of incentives in driving behavior; and (4) the limitations and tradeoffs surrounding regulation.

The perils of duration mismatching are nothing new, but it often takes an exogenous factor to expose them. While SVB appeared to have sufficient liquid assets to attend to normal banking activity, attempting to monetize longer duration, hold-to-maturity (HTM) assets at significant losses to feed overwhelming withdrawals served only to accelerate the momentum behind the flight of deposits. That naturally leads to the second lesson surrounding what led to the run on SVB and the greatest culprit is likely weak risk management. A combination of industry concentration (start-up companies and VCs) and unhedged exposure to longer duration (and, therefore, interest rate sensitive) assets appears to be the smoking gun. This is where incentives and regulatory shortcomings start to come into focus. An extended period of unusually low interest rates challenged the fundamental banking model of generating a spread between what depositors are paid for parking their money at the bank and what the bank earns on reinvesting those deposits in safe and, hopefully, duration-matched investments. A regulatory wrinkle, likely intended to incentivize investment in said securities, allows banks to hold these assets at cost (rather than marking-them-to-market) so long as they are classified as HTM. If one subscribes to the efficient market theory (i.e., limited arbitrage) and believes that interest rates are unlikely to move dramatically (and the accounting penalty if rates do move is non-existent), reaching for yield and buying unhedged exposure to longer-dated rated securities may seem perfectly reasonable. What could go wrong? To be sure, one could also make an argument that a lighter regulatory touch on banks not viewed as systemically important may have contributed to the breakdown of confidence in our banking system.

Our Views: The US distributed financial system is one of our greatest assets. It allows for the efficient flows of capital to its most productive uses, irrespective of where you are in the country. It is, as such, key to fueling GDP growth and the innovation engine that allows the US to remain competitive globally. We will not pretend to have a solution to the Rubik's cube that creates the right balance between regulatory oversight, incentive alignment and risk management among stakeholders in the system, but it’s clear that the industry will be contending with the aftermath of current banking crisis for some time to come. We do expect one of the consequences to be that direct lending will shoulder a greater burden in providing financing for the small and medium sized enterprises that are the engine of our economic prosperity. While this creates powerful and likely sustainable tailwinds for our industry, practitioners and stakeholders in our market should never forget the key lessons of duration matching, robust risk management and the alignment of incentives.

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