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Silicon Wall Street: The Story of Silicon Valley Bank and Fintech Nonbanks

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Abstract:

The extraordinary wealth created by digital platforms in Silicon Valley threatens the purview of Wall Street high finance and banking. Concerns came to a head in 2023 with the bankruptcy of Silicon Valley Bank, the second largest bank failure in history and the first major digital bank run. What happened? What does the bankruptcy suggest about the changing power dynamics between Silicon Valley digital platforms and East Coast bankers and regulators? What is the future of Silicon Wall Street?

Keywords: Silicon Wall Street, Silicon Valley Bank, fintech, Federal Reserve

Introduction

The term 'Silicon Wall Street' reflects a 21st century phenomenon whereby Silicon Valley platforms have become formidable challengers to Wall Street's traditional high finance and banking purview. As the digital economy took off in the 2010s, rapidly growing software firms could avoid Wall Street dictates by finding private investors more than willing to cash in on tech products that were becoming wildly popular around the world (e.g., gaming, social media, e-commerce, mobile devices, and texting). Digital platforms could use their cloud computing and data analytics capabilities to compete head-on with bankers. They created their own term, *fintech*, which is when financial services are provided by technology firms. By the 2020s, Silicon Valley began dominating fintech and traditional banking, an outcome that makes Wall Street bankers nervous.

Concerns came to a head on March 9, 2023, when news broke of the bankruptcy of Silicon Valley Bank. At once, the world saw the second largest bank failure in history and the first major digital run on a bank. Silicon Valley Bank swiftly sought a backstop from traditional East Coast financial institutions, who were more than eager to regain control.

What happened at Silicon Valley Bank? What caused the bankruptcy? Something as big as Silicon Valley Bank's collapse is really quite simple, yet the story is presented to the public with unnecessary complexity. This article is an attempt to make what happened accessible to anyone who's had a bank account. The outcome leaves us wondering about the changing power dynamics between Silicon Valley digital firms and Wall Street bankers and regulators. What does the bankruptcy portend for the future of so-called Silicon Wall Street and the stability of the U.S. financial industry?

East Coast Banking

Commercial success relies on swift and trustworthy banking. As businesses grow, the need for equity and debt capital also grows. Traditional Wall Street financial firms have served as the backbone of economic growth for more than two centuries in the United States. The financial industry expanded and adapted, offering a range of financial products to help businesses handle risk and make money.

Financial firms invest large sums of their own money on hardware to transfer data between financial hubs. Telegraphs were a boon for bankers beginning in the 1840s to transmit data through overhead wires between Manhattan, Philadelphia, Boston, and the Mid-West. Undersea telegraph cables were next, connecting the U.S. with Europe. Then came terrestrial and undersea fiber optic data cables crisscrossing the globe, enabling swift and reliable transfers of money within nanoseconds.

Most recently, firms are using wireless data transfers through sophisticated satellite systems such as the BeiDou-3 global navigation satellite system, completed in the summer of 2020 by the People's Republic of China as a critical component of its Digital Silk Road initiative (Flynn, 2023).

This new telecommunications connectivity has enabled Silicon Valley platforms to become adroit nonbank financial hubs. Silicon Wall Street is redesigning U.S. banking and creating financial instabilities in the process, as we saw in 2023 with Silicon Valley Bank.

Silicon Valley Bank

Silicon Valley Bank was created in 1983 to cater to the computer hardware and software firms that were emerging in the corridor between San Francisco and Palo Alto, California. The bank successfully managed the ebbs and flows of the silicon-based industry through the vicissitudes of Y2K, financial crisis of the late 2000s and Covid-19 global pandemic. By the 2020s, the majority of its customers were venture capital-related clients eager to capitalize on the latest technological capabilities.

The CEO of Silicon Valley Bank, Greg Becker, took measures to shield his bank from regulators. In 2017, Becker joined lobbyists at the American Bankers Associate and the Bank Policy Institute to seek a carve-out to the Federal Reserve's Volcker Rule that was put in place to prevent U.S. Federal Deposit Insurance Corporation (FDIC) insured banks from owning or investing in risky private equity and hedge funds, deemed illiquid assets. Silicon Valley Bank was successful: the Federal Reserve granted the bank a 5-year reprieve from the Volcker Rule. The exemption was extended to the entire banking industry later by the Trump Administration, a policy that went into effect in October 2020. The outcome was further engagement in high-risk activities by deposit-taking commercial banks.

In 2018-2019, Becker returned to DC to lobby the U.S. Congress for Silicon Valley Bank to be exempt from a regulatory provision in the Dodd-Frank Consumer Protection Act, created in the aftermath of the 2008-09 Wall Street financial meltdown. The U.S. Congress was motivated to create such regulations by the staggering $17 trillion price tag associated with the federal government's financial backstop to save failing banks and wealthy investors during the 2008-09 Wall Street meltdown. Poor risk management in the financial industry was squarely on the radar of the federal government. Little did the government know that they would repeat the backstop playbook during the Covid-19 global pandemic, costing the nation an additional $23 trillion.[1]

The specific provision in the Dodd-Frank Act of interest to Becker was the requirement that any financial institution with more than $50 billion in assets would be subject to regulatory stress tests to catch poor risk management by bankers ex-ante.[2] Becker's lobbying activities were successful once again:

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[1] Where did the Fed money go? Banks did not lend it out to customers, as anticipated. Instead, the funds went into (a) dividends and stock repurchases, (b) excess reserves housed at the Federal Reserve, and (c) corporate loans. Thus, the U.S. economy did not rebound quickly, jobs did not fully recover, and wealth became more unequally distributed (Petrou, 2023.)

[2] "The Federal Reserve's stress test assesses whether banks are sufficiently capitalized to absorb losses during stressful conditions while meeting obligations to creditors and counterparties and continuing to be able to lend to households and businesses." https://www.federalreserve.gov/supervisionreg/stress-tests-capital-planning.htm.

Congress raised the regulatory asset threshold from $50 billion to $250 billion to qualify for stress tests. Becker's bank oversaw $209 billion in assets by the end of 2022. Thus, it had not undergone any Dodd-Frank stress tests that might have flagged the bank's problems.

What else got the bank in trouble? During the 14-year stretch of near-zero federal funds (interest) rates set by the Federal Reserve to 2022, banks were not factoring into their decisions what might happen to asset values when interest rates rose again. During the Covid-19 crisis, banks such as Silicon Valley Bank put much of their deposits into long-term Treasury bonds and mortgage bonds backed by government agencies (some $6 trillion industrywide in 2022). It seemed like a low-risk strategy until the Fed raised interest rates ten times between March 2022 and May 2023. This put Silicon Valley Bank in a risky position because as interest rates rose, the value of their bond holdings plunged. The bank did not manage falling asset values in real time, hence putting depositors at risk.

Then the largest digital run on a bank occurred during the first week of March 2023. Thanks to digital banking, Silicon Valley Bank's venture capitalist clientele quickly surmised that the bank would not have enough money to cover deposits. Depositors were scared; they understand interest rate risk. In today's world of Silicon Wall Street, there is no need to go to the bank and stand in a line of panicked depositors trying to get money out of the bank before it runs out of cash. Rather, in rapid succession, customers electronically withdrew their money out of Silicon Valley Bank, $42 billion worth on March 9 alone, a quarter of the bank's total deposits.

This was a new twist on a classic bank run. The bank tried offering higher interest payments on deposits to stop people from withdrawing cash. The bank, however, could not immediately sell its long-term assets to raise sufficient cash. Hence, it declared bankruptcy on March 17, 2023.

The Bailout

In theory, that would be the end of it and the standard liquidation process would ensue. But that is not what happened. Rather than having to pay the consequences of poor risk management, Silicon Valley Bank and their constituents turned to the government for a bailout. The FDIC and Federal Reserve gladly obliged, happy to regain their perceived control of the banking system.

Here is what transpired:

- The Federal Reserve immediately opened its discount window to allow member banks to access cash swiftly at a very low interest rate – including Silicon Valley Bank.
- The Federal Reserve promised to lend up to $165 billion secured against banks' Treasury bonds valued at 100 cents on the dollar – no haircut.[3]
- The U.S. Federal Deposit Insurance Corporation increased the amount it would cover per customer from $250,000 to however much a person had deposited in the bank – no limit.[4]

As a result, the unrealized losses on Silicon Valley Bank's bond holdings did not cause a collapse of the bank. The message is that reckless banking will be rewarded. Moral hazard remains *de jour*: poor decision-making will persist if bankers know the federal government will bail them out. "Either this was an indefensible overreaction, or there is much more rot in the American banking system than those of us on the outside of confidential supervisory information can even know," concluded University of Pennsylvania financial historian, Peter Conti-Brown (The Economist, 2023a:60).

First Citizens BancShares acquired Silicon Valley Bank from the FDIC in April 2023. It bought $72 billion of Silicon Valley Bank's loans, cleverly at a 23 percent haircut.

[3] A hair cut is a reduction applied to the value of an asset during a debt restructuring, bailout, or buyout.
[4] At the end of 2022, 90 percent of Silicon Valley Bank's deposits were over the $250,000 FDIC-insured cap.

Bank Term Funding Program

The question now is what will happen with the estimated $500 to $620 billion in unrealized losses on bonds in the 4,700 other U.S. banks and savings institutions? Will the federal government have to facilitate emergency rescues of these entities in the event of paper losses on balance sheets?

It appears so, given the Federal Reserve's decision to establish the *Bank Term Funding Program*, effective March 12, 2023.[5] The program temporarily immunizes troubled banks from the decline in prices of Treasury bonds and mortgage-backed securities that occurred as a result of the Fed's swift increase in interest rates in 2022-23.[6] The new program allows members that need cash to present its depreciated Treasury bonds and receive full (par) value for up to one year.

The Federal Reserve estimates that paper losses at U.S. banks may reach as much as $1.7 trillion in the near term. Professor James Galbraith refers to the Fed's new Bank Term Funding Program as "a safety net for a systemic crisis—a crisis created by the Federal Reserve itself" (2023).

The financial instability revealed in Spring of 2023 is also linked to bank audits. Since the collapse of Silicon Valley Bank in March 2023, two other large bank failures occurred within weeks, beginning at First Republic Bank in San Francisco and then Signature Bank in New York, both of which required government intervention. In all three cases, the Big Four accounting firm, KPMG, was the auditor of record that "gave these banks' financial statements a clean bill of health as recently as the end of February" 2023 (Financial Times, May 4, 2023a).

Silicon Wall Street

Silicon Valley Bank's failure provides an opening to understand significant shifts that have taken place in finance during the first two decades of the 21st century and the status of high finance today. Silicon Valley no longer needs traditional banks because they can provide banking services powered by their digital platforms. Moving forward, cloud computing and data analytics capabilities will increasingly enable fintech nonbanks to compete head-on with commercial bankers and investment bankers by offering peer-to-peer (P2P) direct payments for quick cash transfers, retail-based trading, apps that bundle banking services onto mobile devices, buy now-pay later credit cards, digital cash equivalents, and standard consumer-finance services.

Large tech platforms originating in Silicon Valley have used their digital systems to quietly enter Wall Street's world of banking. They benefit because they can skirt U.S. laws that bar banks from commerce, established to mitigate conflicts of interest between borrowers and lenders. Tech-based financial intermediaries are the least regulated money movers today. What we saw happen with Silicon Valley Bank could easily spread to nonbank digital platforms entering the consumer finance industry in the event they issue more debt than they can honor.[7]

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[5] https://www.federalreserve.gov/financial-stability/files/bank-term-funding-program-faqs.pdf.

[6] Rising interest rates depressed the value of Treasury bonds and caused big depositors to swiftly withdraw their money and put it into higher-yielding Treasury bills, leaving the banks short on cash. Questions are being raised as to the wisdom of the Federal Reserve inverting the yield curve as a means of driving down inflation in 2022-23, a decision with ramifications unfolding in the interconnected world banking system.

[7] A potential case in point is Starbucks. As of April 2, 2023, the coffee firm had $1.8 billion worth of money yet unspent that customers had loaded onto the Starbucks app. "If Starbuck was a bank, that would make it bigger than 90 percent of institutions covered by the U.S. Federal Deposit Insurance Corporation by deposit size" (Financial Times, May 4, 2023b). As a non-bank, the FDIC does not require Starbucks to keep money in reserve in the event customers decide to cash in on their rewards program at once.

Conclusion

In 2023, we witnessed the largest bank bankruptcies in U.S. history and the largest digital run on a bank.[8] Silicon Valley's foray into banking has created economic uncertainties and instabilities across the United States with ramifications for other countries dependent upon Federal Reserve policies.

As with the national economic crises in 2008-09 and 2020-21, the Federal Reserve brokered enormous backstops to save banks and nonbanks in Spring 2023. This time, however, was different:

[The Federal Reserve's] assistance has been far more lavish than in previous rescues. When providing emergency credit, it is normally conservative in its collateral rules, using spot (current) prices to value the securities that banks hand over in exchange for cash. Moreover, it aims to lend only to solvent firms. This time, however, the Fed accepted government bonds at face value, even though their actual value had fallen sharply. That is remarkable (The Economist, March 18, 2023b: 66).

President Joe Biden was satisfied, reporting that the administration had done "a pretty damn good job" fighting this financial fire brought on by Silicon Valley Bank (Samuels, 2023:1). Where is the country's leadership when we need financial help that solves short-term problems without creating long-term problems?

On June 22, 2023, the U.S. Senate Banking Committee put forth the *Recovering Executive Compensation Obtained from Unaccountable Practices Act of 2023* (S. 2190 RECOUP Act) to prevent a repeat of the Silicon Valley Bank scenario.[9] If passed, the bill will enable the U.S. FDIC to claw-back bonuses and stock compensation that senior bank executives took in the two years before a bank failure. A fine of up to $3 million could also be levied. The aim is to encourage better risk management by requiring banking executives to retain skin in the game when dealing with depositors' money.

The story of Silicon Valley Bank ends with a warning about the future of banking, specifically a call for the Federal Reserve to use its clout to curtail the instability created by the workings of modern banks and nonbanks. It is time for the Federal Reserve to step back from its role as lender of last resort and provide emergency liquidity only to solvent banks, at penalty rates, in exchange for good collateral.

To support the general welfare of society, monetary policy and financial-stability protection are best linked. Otherwise, the boom-bust-bailout cycle will continue unabated to the detriment of the world economy.

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[8] The two largest bank failures in the U.S. were Washington Mutual in Seattle, Washington (2008; $307 bn in asset) and First Republic Bank in San Francisco, Washington (2023; $229 bn in assets), the latter of which transpired within a month of the Silicon Valley Bank collapse (2023; $209 bn in assets).

[9] "This bill establishes additional authorities for federal banking agencies and sets forth requirements for insured depository institutions with assets over a specified amount to address their safety and soundness. In the event of institutional failure, the bill establishes the authority to recover from a senior executive bonus compensation and profits from the sale of securities received during the 24-month period preceding the failure. Federal banking authorities also have the authority at an institution of any size to remove from office a senior executive in cases of gross negligence, breach of fiduciary duty, or failure to carry out specified responsibilities." https://www.congress.gov/bill/118th-congress/senate-bill/2190.

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