Is Western Alliance Bank In Trouble?

Depositors of Western Alliance find themselves thinking the same thoughts today.

Will their accounts be ok?

Of course, we all know to keep our accounts maxed out at $250,000. As a result of Uncle Sam's guarantee via FDIC: Federal Deposit Insurance Corporation. Remember any amount above that rests on President Biden's guarantee. Not quite the same thing.

Everyone sees the stock in free fall and feels panic regardless of the guarantee.

Then global ratings firm Moody's Investors Service drops an axe: Research: Rating Action: Moody's places Western Alliance's ratings on review for downgrade – Moody's (moodys.com)

Wall Street research and banking house Wedbush wrote about Western Alliance that they; "had a fair market value 92% below its book value based on generally accepted accounting principles (GAAP) for publicly traded U.S. companies."

Thats pretty terrible. Essentially book value from an "honest perspective" regarding where their assets would sell for TODAY. Puts the bank at less than 10 cents on the dollar for their reported worth.

That puts them in awful company with Silicon Valley Bank.

Let's take a look at the whole industry:

These unrealized losses are NOT reflected in profits or a deduct to equity via Other Comprehensive Income (OCI) – only in the footnotes! Moreover, we don't find these losses reflected in stress tests or measures of capital adequacy.

Furthermore a 25 bp (1/4 of 1 percent) increase in rates for a 10-year security causes approximately 2 points in losses (100 par to 98 to reflect yield discount).

Lately all we can read about these days are banks failing everywhere! Are we in a financial crisis? Now some worry Will Bank of America Collapse?

And many others worry whether or not there is a Hawaii Bank Run? And of course, many others worry about the more local establishments. Will First Republic Bank Fail ?

Western Alliance Bank is a financial institution that operates in the western United States. In addition, the bank's history dates back to 1994 when Robert Sarver founded the National Bank of Arizona in Tucson, Arizona.

Under Sarver's leadership, the National Bank of Arizona grew rapidly, acquiring several other banks and expanding its reach across the state. In 2002, the bank merged with Western Alliance Bancorporation, a holding company that owned several other banks in the region, to form Western Alliance Bank.

Acquiring other banks and opening new branches in Arizona, Nevada, California, and Colorado. Furthermore, in the mid-2000s, the bank began to focus on serving niche industries like healthcare, technology, and gaming, offering specialized products and services tailored to the needs of these businesses.

In the years since, Western Alliance Bank has continued to innovate and adapt to changing market conditions. Furthermore, introducing new technologies and expanding its offerings in areas like commercial lending, treasury management, and international banking.

In conclusion, today, Western Alliance Bank now one of the largest regional banks in the western United States. Lastly, with over $30 billion in assets and more than 40 offices across the region.

1. Research: Rating Action: Moody's places Western Alliance's ratings on review for downgrade – Moody's (moodys.com)
2. Unrealized Losses Have Piled Up at Regional Banks Facing Credit Downgrades: Report (investopedia.com)
3. Moody's places First Republic Bank's ratings under review for downgrade."
4. Moody's Analytics. "Moody's places Western Alliance's ratings on review for downgrade."
5. Board of Governors of the Federal Reserve System. "Federal Reserve Board announces it will make available additional funding to eligible depository institutions to help assure banks have the ability to meet the needs of all their depositors

Will Wells Fargo Fail?

That's the question of the day. Will one of the great American banks face demise for purchasing too much debt at the height of the recent bond bubble. And of course not hedging that debt with proper risk management. Similar to Silicon Valley Bank. See our piece: What caused the run on Silicon Valley Bank?

Now Wells Fargo finds itself in the hot seat. Which surprises few in the financial world. As the bank has a history of lax risk management practices. They were the ones creating fake accounts in people's names to pad their numbers. Their CEO 15 years ago was great, but he became forced out sadly and since they have been going downhill steadily from an image standpoint.

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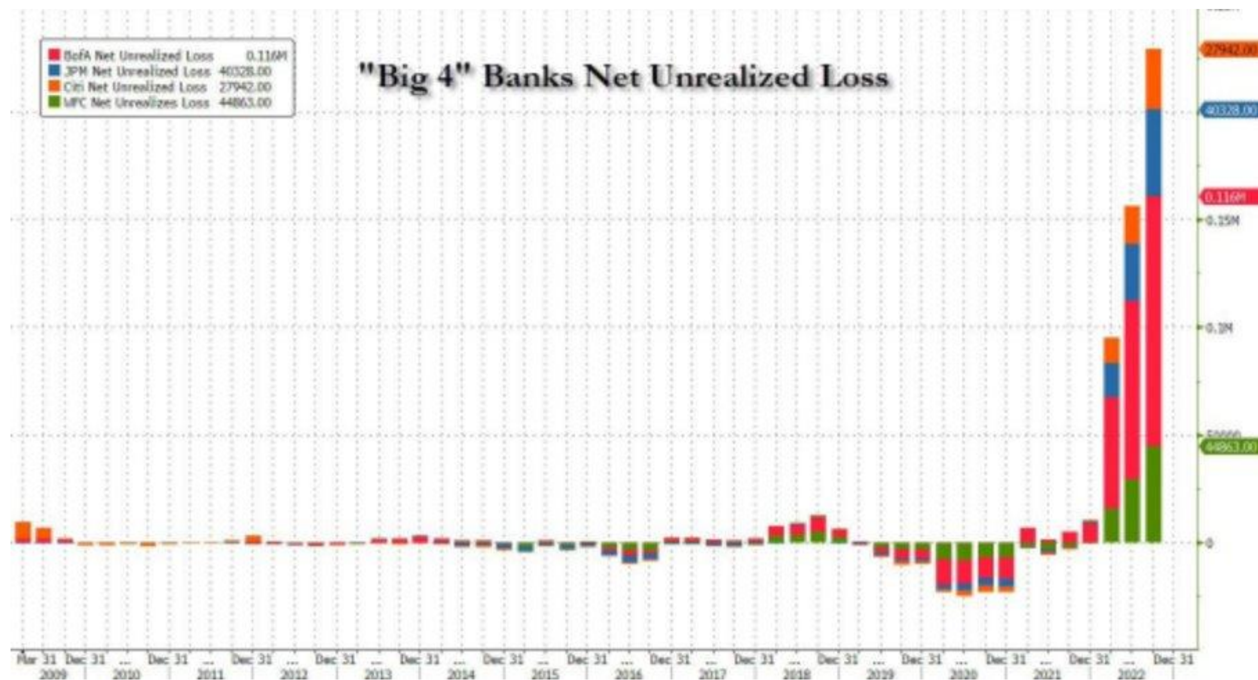
Furthermore a 25 bp (1/4 of 1 percent) increase in rates for a 10-year security causes approximately 2 points in losses (100 par to 98 to reflect yield discount).

Wells sits awash in net unrealized losses, see chart:



Will Bank of America Collapse?

Are we in a financial crisis?

Let's look at their long and complex history!

The company was founded in 1852 by Henry Wells and William Fargo, both of whom had experience in the transportation industry. Initially, the company was called Wells, Fargo & Company and focused on providing express delivery services to customers in California.

During the California Gold Rush, Wells Fargo played a key role in transporting gold and other valuable items across the country. In addition to its express delivery services, the company also began offering banking and other financial services to its customers.

In the late 19th and early 20th centuries, Wells Fargo became a major player in the banking industry, opening branches across the United States and acquiring other banks and financial institutions. However, the company also faced numerous scandals and controversies, including accusations of predatory lending practices and discriminatory treatment of customers.

In the aftermath of the 2008 financial crisis, Wells Fargo faced additional scrutiny over its business practices.

Wells Fargo to pay $148 million fine for Wachovia misdeeds – Dec. 8, 2011 (cnn.com)

Wells Fargo to pay $175 million in race discrimination probe | Reuters

Furthermore, in 2016, the company became fined $185 million for opening millions of unauthorized accounts on behalf of its customers. As a result, leading to the resignation of its CEO and other senior executives.

Then in 2018, Wells Fargo faces $1 billion fine from loan abuses | Reuters

Just in December, Wells Fargo to pay $3.7 billion settlement over latest allegations of "illegal activity" – CBS News!

Ex-Wells Fargo leaders personally face $59 million in fines – Los Angeles Times (latimes.com)

Despite these challenges, Wells Fargo remains one of the largest and most influential financial services companies in the world. With operations in more than 40 countries and over 250,000 employees.

Wells Fargo to Pay $37M to Settle Fraud Lawsuit | ThinkAdvisor

In conclusion, lately all we can read about these days are banks failing everywhere! Are we in a financial crisis? Now some worry will Bank of America collapse? And many others worry whether or not will Wells Fargo fail?

And lastly, of course, many others worry about whether the more local establishments can keep breathing. Will First Republic Bank fail? Or is my money Safe in Schwab?

Will Wells Fargo Fail?

The Silicon Valley Bank failure strikes me as a colossal failure of bank regulation, and instructive on how rotten the whole edifice is. I write this post in an inquisitive spirit. I don't know the details of how SVB was regulated, and I hope some readers do and can chime in.

As reported so far by media, the collapse was breathtakingly simple. SVB paid a bit higher interest rates than the measly 0.01% (yes) that Chase offers. It attracted large deposits from venture capital backed firms in the valley. Crucially, only the first $250,000 are insured, so most of those deposits are uninsured. The deposits are financially savvy customers who know they have to get in line first should anything go wrong. SVB put much of that money into long-maturity bonds, hoping to reap the difference between slightly higher long-term interest rates and what it pays on deposits. But as we've known for hundreds of years, if interest rates rise, then the market value of those long-term bonds fall. Now if everyone comes asking for their money back, the assets are not worth enough to pay everyone back.

We teach this in the first week of an MBA or undergraduate banking class. This isn't crypto or derivatives or special purpose vehicles or anything fancy.

Where were the regulators? The Dodd Frank act added hundreds of thousands of pages of regulations, and an army of hundreds of regulators. The Fed enacts "stress tests" in case regular regulation fails. How can this massive architecture fail to spot basic duration mismatch and a massive run-prone deposit base? It's not hard to fix, either. Banks can quickly enter swap contracts to cheaply alter their exposure to interest rate risk without selling the whole asset portfolio.

Even Q3 2022 — a long time ago — SVB was a huge outlier in having next to no retail deposits (vertical axis, "sticky" because they are insured and regular people), and a huge asset base of loans and securities.

Michael then asks

.. how much duration risk did each bank take in its investment portfolio during the deposit surge, and how much was invested at the lows in Treasury and Agency yields? As a proxy for these questions now that rates have risen, we can examine the impact on Common Equity Tier 1 Capital ratios from an assumed immediate realization of unrealized securities losses … That's what is shown in the first chart: again, SVB was in a duration world of its own as of the end of 2022, which is remarkable given its funding profile shown earlier.

Again, in simpler terms. "Capital" is the value of assets (loans, securities) less debt (mostly deposits). But banks are allowed to put long-term assets into a "hold to maturity" bucket, and not count declines in the market value of those assets. That's great, unless people knock on the door and ask for their money now, in which case the bank has to sell the securities, and then it realizes the market value. Michael simply asked how much each bank was worth in Q42002 if it actually had to sell its assets. A bit less in each case — except SVB (third from left) where the answer is essentially zero. And Michael just used public data. This is not a hard calculation for the Fed's team of dozens of regulators assigned to each large bank.

Perhaps the rules are at fault?

If a regulator allows "hold to maturity" accounting, then, as above, they might think the bank is fine. But are regulators really so blind? Are the hundreds of thousands of pages of rules stopping

them from making basic duration calculations that you can do in an afternoon? If so, a bonfire is in order.

This isn't the first time. Notice that when SBF was pillaging FTX customer funds for proprietary trading, the SEC *did not say* "we knew all about this but didn't have enough rules to stop it." The Bank of England just missed a collapse of pension funds who were doing exactly the same thing: borrowing against their long bonds to double up, and forgetting that occasionally markets go the wrong way and you have to sell to make margin calls. (That's week 2 of the MBA class.)

"The aftermath of these two cases is evidence of a significant supervisory problem," said Karen Petrou, managing partner of Federal Financial Analytics, a regulatory advisory firm for the banking industry. "That's why we have fleets of bank examiners, and that's what they're supposed to be doing."

The Federal Reserve was the primary federal regulator for both banks.

Notably, the risks at the two firms were lurking in plain sight. A rapid rise in assets and deposits was recorded on their balance sheets, and mounting losses on bond holdings were evident in notes to their financial statements.

moreover,

"Rapid growth should always be at least a yellow flag for supervisors," said Daniel Tarullo, a former Federal Reserve governor who was the central bank's point person on regulation following the financial crisis…

In addition, nearly 90% of SVB's deposits were uninsured, making them more prone to flight in times of trouble since the Federal Deposit Insurance Corp. doesn't stand behind them.

90% is a big number. Hard to miss. The article echoes some confusion about "liquidity"

SVB and Silvergate both had less onerous liquidity rules than the biggest banks. In the wake of the failures, regulators may take a fresh look at liquidity rules,…

This is absolutely not about liquidity.

SBV would have been underwater if it sold all its securities at the bid prices. Also

Silvergate and SVB may have been particularly susceptible to the change in economic conditions because they concentrated their businesses in boom-bust sectors…

That suggests the need for regulators to take a broader view of the risks in the financial system. "All the financial regulators need to start taking charge and thinking through the structural consequences of what's happening right now," she [Saule Omarova] said

There is a larger implication. The Fed faces many headwinds in its interest rate raising effort. For example, each point of higher real interest rates raises interest costs on the debt by about $250 billion (1 percent x 100% debt/GDP ratio). A rate rise that leads to recession will lead to more stimulus and bailout, which is what fed inflation in the first place.

But now we have another. If the Fed has allowed duration risk to seep in to the too-big to fail banking system, then interest rate rises will induce the hard choice between yet more bailout and a financial storm. Let us hope the problem is more limited – as Michael's graphs suggest.

Why did SVB do it?

How could they be so blind to the idea that interest rates might rise? Why did Silicon Valley startups risk cash, that they now claim will force them to bankruptcy, in uninsured deposits? Well, they're already clamoring for a bailout. And given 2020, in which the Fed bailed out even money market funds, the idea that surely a bailout will rescue us should anything go wrong might have had something to do with it.

(On the startup bailout. It is claimed that the startups who put all their cash in SVB will now be forced to close, so get going with the bailout now. It is not startups who lose money, it is their venture capital investors, and it is they who benefit from the bailout.

Let us presume they don't suffer sunk cost fallacy. You have a great company, worth investing $10 million. The company loses $5 million of your cash before they had a chance to spend it. That loss obviously has nothing to do with the company's prospects. What do you do? Obviously, pony up another $5 million and get it going again. And tell them to put their cash in a real bank this time.)

How could this enormous regulatory architecture miss something so simple?

This is something we should be asking more generally. 8% inflation. Apparently simple bank failures. What went wrong? Everyone I know at the Fed are smart, hard working, honest and dedicated public servants. It's about the least political agency in Washington. Yet how can we be seeing such simple o-ring level failures?

I can only conclude that this overall architecture — allow large leverage, assume regulators will spot risks — is inherently broken. If such good people are working in a system that cannot spot something so simple, the project is hopeless. After all, a portfolio of long-term treasuries is about the safest thing on the planet — unless it is financed by hot money deposits. Why do we have teams of regulators looking over the safest assets on the planet? And failing? Time to start over, as I argued in Towards a run free financial system

Or… back to my first question, am I missing something?

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Updates:

A nice explainer thread (HT marginal revolution). VC invests in a new company. SVB offers an additional few million in debt, with one catch, the company must use SVB as the bank for deposits. Furthrmore, SVB invests the deposits in long-term mortgage backed securities. SVB basically prints up money to use for its investment!

"SVB goes to founders right after they raise a very, very expensive venture round from top venture firms offering:

– 10-30% of the round in debt

– 12-24 month term

– interest only with a balloon payment

– at a rate just above prime

If your PortCo doesn't need it, the cash just sits. If they do, it might save them in a crunch. The deals typically have deposit covenants attached. Meaning: you borrow from us, you bank with us.

And everyone is broadly okay with that deal. It's a pretty easy sell! "You need somewhere to put your money. Why not put it with us and get cheap capital too?"

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